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Ex Parte

September 12, 1996

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW
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**Re: "Rules and Policies for the Local Multipoint Distribution Service (LMDS)"
CC Docket 92-297**

On July 22, 1996, the Commission released its Fourth Notice of Proposed Rulemaking ("Fourth Notice") in the above referenced proceeding. Among other things, the Fourth Notice seeks comment on whether to restrict the eligibility of local exchange carriers ("LECs") and cable system operators to acquire LMDS licenses in their respective markets. Bell Atlantic opposes any eligibility restrictions, and filed comments with the Commission supporting our position on August 12, 1996.

Bell Atlantic believes that an "open entry" policy is the only way to allocate spectrum resources in a manner that is competitively fair, will ensure that services are provided to the public rapidly, and will yield the maximum payment for licenses auctioned. Such a policy is consistent with the recently enacted Telecommunications Act of 1996, as well as Commission policy regarding a variety of wireless services for which the Commission has recently adopted rules.

In the Fourth Notice, several parties to this proceeding raised concerns about the potential for LECs to acquire LMDS as a means for preempting competitive entry into the local exchange market. These parties also questioned the likelihood of efficiencies and/or economies produced from LEC LMDS operations. Attached is a paper written by Strategic Policy Research ("SPR") which examines these issues from an economic perspective.

Prospects for Competitive Preemption

Proponents of license eligibility restrictions suggest that LECs will acquire LMDS licenses as an attempt to preempt competitive entry. They base their claims on the presumption that LECs have an incentive to protect monopoly profits. SPR clearly

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concludes that, contrary to these claims, LECs do not have an incentive to credibly and profitably preempt competition. The conditions posited for the plausibility of competitive preemption are not satisfied in the context of LECs and LMDS technology. LECs cannot be expected to earn monopoly profits in the future given new procompetitive government policies and increased competition from a variety of alternative sources.

The Telecommunications Act of 1996 (“Act”) ushers in a new era of competition in the telecommunications industry whereby previously distinct market segments will converge. One of the fundamental goals of the Act was to remove barriers to market entry, not erect them. Moreover, Congress specifically recognized the benefits of LEC entry into the video programming market, including through the use of LMDS technology (see Bell Atlantic comments). Any restrictions on the LECs’ ability to acquire LMDS licenses might undermine this important public policy objective. In addition to removing market entry barriers, the Act instructs the FCC to adopt policies to ensure that local competition develops, e.g., LEC interconnection rules. Implementation of these policies, and the competition that will develop as a result, will act to ensure that LEC monopoly profits do not exist. There is, therefore, no justifiable reason to impose artificial constraints on the LECs’ use of certain technologies; technologies which may yield substantial benefits for consumers.

Importantly, SPR finds that the prospects for successful competitive preemption are unlikely given an increasingly large number of alternative sources of LEC competition, which include long distance carriers, competitive access providers, cable system operators, cellular and PCS carriers, satellite-based services, and fixed microwave services like those offered by WinStar and Associated Communications. In fact, the list of existing and potential competitors to the LECs is enormous. Attached is an information package which provides a small sample of the ways in which companies are already competing, or planning to compete, with the LECs. Given the proliferation of local competition that will exist in the future, it is inconceivable that any LEC would have the incentive to profitably preempt competition simply by acquiring an LMDS license.

LEC LMDS Efficiencies

Proponents of license eligibility restrictions also claim that LEC use of LMDS technology would not yield efficiencies/economies significant enough to justify their eligibility. If any potential efficiencies do exist, they claim that they are no greater than those that would be realized by other competitors. SPR finds these claims to be false. In the context of its PCS rulemaking, the Commission determined that the LECs’ use of wireless technology might produce “significant economies of scope”, and therefore, concluded that LECs should be eligible for PCS. The potential efficiencies/economies for LMDS are, SPR finds, no less significant. The argument for LEC LMDS eligibility is therefore equally compelling, and in fact, even more compelling given the likelihood that LMDS will be used to deploy video services which LECs generally do not provide today.

While we believe that the efficiencies/economies which LEC deployment of LMDS might yield are significant, we agree with SPR that “the proof of the scope and magnitude of any efficiencies lies ultimately in their actual realization in the marketplace”. Such efficiencies are likely to be reflected in the bids offered for LMDS licenses. We disagree with the Justice Department’s position that LECs should present quantifiable evidence of such efficiencies, and that they should have a “heavy burden” in demonstrating that such efficiencies outweigh the likelihood for harm to the local telephone market. Submission of quantifiable evidence of such efficiencies would provide an indication of the LECs’ valuation and bidding strategy and a prelude to the auction’s outcome. Such a submission is, we believe, inappropriate. Moreover, it is unnecessary given the fact that LECs have no incentive to preempt competition. Where, as here, there is no incentive to preempt, then there is no potential for harm to the local telephone market by allowing LECs to acquire LMDS licenses.

In summary, I urge the Commission to adopt an “open entry” policy for LMDS that will ensure that the public gets the full benefit from this new technology. Sophistal attempts to limit the competition for these licenses should be ignored, and the Commission should move rapidly to holding service auctions.

Questions regarding this matter can be referred to me on (202) 392-6980, or to Don Brittingham, Director-Wireless Policy, on (202) 392-1189.



Attachments

cc: **Chairman Reed Hundt**
Commissioner Rachelle Chong
Commissioner Susan Ness
Commissioner James Quello

Mr. John Berresford
Ms. Jackie Chorney
Mr. James Coltharp
Ms. Michelle Farquhar
Mr. Joe Farrell
Mr. Thomas Koutsky
Mr. Joe Levin
Ms. Susan Magnotti
Ms. Jane Mago
Mr. David Siddall
Mr. Walter Strack

Economic Disabilities of License Eligibility and Use Restrictions

John Haring
Charles L. Jackson*

Prepared for Bell Atlantic

September 10, 1996

Executive Summary

Proponents of LMDS license eligibility restrictions have, in the case of the LECs, failed to demonstrate the existence of LEC incentives to credibly and *profitably* preempt competition. In addition, they have not effectively disputed the presence of economies of scale and scope for LEC LMDS operations. Thus, requests to impose eligibility restrictions should be rejected.

The conditions posited for the plausibility of competitive preemption are not satisfied in the context of LECs and LMDS technology. LMDS is likely a complement rather than a substitute for existing LEC services. LECs do not earn and cannot be expected to earn monopoly profits in the future given government oversight, increased competition from a variety of alternative sources and new procompetitive government policies.

Given the potential economic advantages associated with offering consumers a one-stop shop, LECs are realistic candidates for efficient deployment of LMDS video capabilities within their service regions. As such, their exclusion is likely to cost the government many hundreds of millions of dollars in foregone auction revenues and deprive consumers of an effective competitive alternative to cable. The potential competitive harms to be balanced against such losses have not been compellingly demonstrated. In our view, it makes no economic sense to penalize the public to make it easier for less efficient competitors to acquire valuable spectrum resource rights at bargain rates.

* The authors are principals in Strategic Policy Research, Inc. Dr. Haring formerly served as Chief Economist of the FCC and Chief of the Commission's Office of Plans and Policy. Dr. Jackson formerly served as Staff Engineer for the House Telecommunications Subcommittee and Engineering Assistant to FCC Commissioner Glen O. Robinson.

Introduction

In the LMDS proceeding,¹ the Commission has solicited comment on the economic wisdom of imposing license eligibility and use restrictions on local exchange carriers (LECs) and cable multiple system operators (MSOs) for in-region LMDS operating rights. In this submission, we explain our reasons for concluding that restrictions on LEC license eligibility and resource use are not only unwarranted, but likely to reduce economic welfare. The premises that proponents posit as a basis for imposing eligibility restrictions are invalid in the case of the LECs. Moreover, proponents' claim that restrictions will not entail efficiency losses is belied by current undertakings in the marketplace and the likelihood of economies of scale and scope for LEC LMDS operations.² In the absence of plausible benefits and given the significant likelihood of foregone efficiencies and lower auction revenues, the arguments of potential auction competitors should be perceived for what they are — sophistal attempts to limit competition in hopes of acquiring valuable resources rights on more favorable terms and to exclude rivals who are likely to prove formidable competitors.

Free Competition Paradigm

The intellectual case for free competition (and against license eligibility and use restrictions) ultimately rests on the superiority of a free competitive process as a means for determining how market needs should be met. The productive capabilities of producers (including their ability to exploit any potential economies of scale or scope) and the preferences of consumers (including the the products they want to purchase and how much they are willing to pay) are not *given* facts. The fact that an economist makes assertions about the character of a particular productive technology³ does not alter the fundamental scarcity of economically relevant information. Indeed, it exacerbates

¹ *Fourth Notice of Proposed Rulemaking*, In the Matter of Rulemaking to Amend Parts 1,2, 21, and 25 of the Commission's Rules to Redesignate the 27.5-29.5 GHz Frequency Band, to reallocate the 29.5-30.0 GHz Frequency Band, to Establish Rules and Policies for Local Multipoint Distribution Service and for Fixed Satellite Services, CC Docket No. 92-297, July 22, 1996.

² As we note (pp. 13-14 *infra*), both AT&T and MCI have undertaken to supply telecommunications and video services on an integrated basis.

³ See, e.g., Kenneth C. Baseman, *The Economics of Bidding for Scarce Resources: The Lessons of Monopoly Preemption as Applied to FCC Auctions of LMDS Licenses*, August 12, 1996.

it if free competitive market processes for authentication of such information are rendered less effective as a consequence.⁴

If all relevant information about productive technologies and opportunities and consumer tastes and preferences were freely given, there would be little need for competition and free enterprise. Government central planners could simply take these “givens” and determine directly what goods should be produced and what technologies should be employed. In the LMDS context, the government assumedly would possess all knowledge of relevant productive technology (including the nature of any economic and technical interrelationships with other technologies), would know the most highly valued use of LMDS spectrum resource rights, would know the specific identities of the producers capable of maximizing economic surplus, and could award resource rights directly to efficient producers in exchange for precisely the discounted value of any expected future surplus these producers would subsequently realize from sales to consumers.

Since, in reality, this type of information is not given to anyone in its totality, alternative institutional means are necessary to determine how best to allocate productive resources. In the U.S. market economy, free competition is generally the primary means utilized to determine what goods should be produced, for whom and by what means. Under the competitive enterprise system, individual competitors are afforded substantial freedom, within the constraints of relevant law, to combine resources however they deem fit in an effort to discover products and services that attract customers and the most efficient methods of producing them. Efforts to economize and to discover and satisfy customers’ demands, even though well conceived, may fail. Sometimes initial ideas prove unworkable and revisions are implemented. Suspected synergies may fail to materialize, while different sources of competitive advantage sometimes appear fortuitously. Through a highly complex process of trial and error, innovation and imitation, experimentation and rationalization of production, the competitive process dynamically allocates scarce resources toward more highly valued employments in production and consumption and away from less efficient alternatives.

Competition is thus usefully conceived as a “discovery procedure,” *i.e.*, as an evolutionary process of discovery and selection in the marketplace. It is generally *through* the process of

⁴ This would occur if, buttressed by such claims, arbitrary restraints on license eligibility and resource use were imposed.

competition that comparative efficiency is established. The authenticity of various kinds of productive efficiencies ultimately turns on their realization in the marketplace.⁵

In a sports contest, the winner is not determined on the basis of team salaries, previous won/lost records, pundit predictions or various individual performance statistics — obviously the winner is determined according to the points scored when the game is actually played. While information on past performance may sometimes be useful for purposes of prediction, the inferences and predictions could be wrong for any number of reasons and would, in virtually no case, supply a more valid or compelling basis for declaring a winner than the results of actually playing the game.

If the competitive process is to prove effective in maximizing the value of the economy's scarce productive resources, competing firms must be afforded substantial freedom in their choice of productive technology and substantial flexibility in the manner in which they deploy different technical capabilities. Artificial/arbitrary restraints on freedom and flexibility in the deployment of productive resources impose artificial/arbitrary limits on the competitive process' ability to identify superior productive efficiency.

If enterprises engaged in supplying consumers' demands for different types of communications services are arbitrarily constrained in their choice of technologies and their selection of an appropriate mix of supply capabilities to address particular demand sets, discovery and exploitation of productive economies arising on any number of scores may be significantly hampered. For example, the type of transport technology most economical to deploy (*viz.*, wired versus wireless) may well vary according to the specific application being considered and other relevant

⁵ As Economic Nobelist F.A. Hayek explained in his famous essay on "The Use of Knowledge in Society":

If we possess all the relevant information, if we can start out from a given system of preferences, and if we command complete knowledge of available means, the problem which remains is purely one of logic. That is, the answer to the question of what is the best use of the available means is implicit in our assumptions. . . . This, however, is emphatically not the economic problem which society faces. . . . The economic problem of society is not merely a problem of how to allocate 'given' resources — if 'given' is taken to mean given to a single mind which deliberately solves the problem set by these 'data.' It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge which is not given to anyone in its totality. Individualism and Economic Order (1948).

characteristics of the operating environment. In a world of differentiated and sometimes idiosyncratic supply capabilities, selective restraints may result in the loss of productive efficiencies that cannot be easily or economically duplicated.

Application to Competitive Auctions

Auctions provide a means for ascertaining the value of particular resource rights and allocating rights to highest valued uses evaluated at particular points in time.⁶ When a resource serves as an input to different production processes, willingness to bid a higher price will tend to reflect the relative superiority of utilizing a particular production process to produce particular goods or producing one set of goods compared to others. That is simply to say that, if one party makes a higher bid than another, it is, generally speaking, reasonable to infer that an assignment of resource rights to that party represents an efficient allocation. The comparative credibility and authenticity of different parties' claims are buttressed by their relative willingness to put their money where their mouths are.

Naturally, in circumstances where exclusion of a prospective bidder might be expected to reduce the amount that needs to be bid to win an auction, other bidders may possess incentives to induce such exclusion. By limiting competition for the resource, those permitted to compete can expect to reap benefits in the form of lower costs for resource acquisition. Such an expectation might be plausible where, for example, the number of bidders affects the intensity of competition in an auction and the magnitude of the resulting revenues. Where there is significant uncertainty over the value of the resource rights being put up for bid, as is widely regarded to be the case in the case of LMDS spectrum rights, the number of bidders can reasonably be expected to affect the intensity of competition and the amount of auction revenues. Where certain parties are particularly well-positioned to exploit potential economies of scale or scope or special competencies, their exclusion can also reasonably be expected to diminish the intensity of competition for the resource and reduce auction revenues.

⁶ As the Commission said "we determined that the use of competitive bidding to award broadband PCS licenses, as compared with other licensing methods, would speed the development and deployment of new services to the public and would encourage efficient use of the spectrum." Docket 93-253, Paragraph 5.

In the LMDS context, some prospective bidders have sought to limit competition by LECs and MSOs by prohibiting them from obtaining LMDS licenses “in-region.”⁷ While conceding the existence of substantial uncertainty and its implications in terms of the direct relationship between auction revenues and the number of bidders, they have argued, counterintuitively, that *exclusion of some prospective bidders will not reduce the number of bidders*. Their argument is that *failure to restrict* license eligibility will discourage some bidders from participating in an auction and, therefore, that by limiting license eligibility the Commission will not necessarily decrease the number of bidders. The thrust of this argument is that, notwithstanding any adverse consequences you may suffer from constraints on your economic and, possibly, First Amendment freedom, there may be no adverse consequence in terms of the intensity of the bidding competition as a result of LMDS eligibility restrictions.⁸

The proponents of this argument concede that limiting license eligibility could reduce auction revenues, but claim that any such losses would reflect a redistribution of income from monopolist to the government fisc rather than any genuine loss of efficiency or reduced economic surplus from misallocation to a lower-valued resource use. They base this claim on two additional claims: (1) the existence of *unregulated* monopoly power producing monopoly rents whose expected value exceed the likely costs of competitive preemption; and (2) the absence of efficiencies from LEC or MSO LMDS operations. We address each of these claims in turn, arguing that the premises necessary for the validity of the first claim are not satisfied in the case of the LECs and that efficiencies may well inhere in LEC LMDS operations.

Quite tellingly, Webcel’s expert discloses in a footnote (Baseman, *op. cit.*, page 3, footnote 6) that he has, in fact, *not assessed* the key analytically pertinent question of whether market power can be exercised given existing federal and state regulation of the LECs. As we demonstrate presently, Baseman’s argument fails in the absence of prospective monopoly profits sufficient to justify sinking an investment in a resource the value of whose productivity is, it is argued, by design

⁷ See, notably, *Comments of Webcel Communications, Inc.*, August 12, 1996 and the previously cited attachment thereto.

⁸ This argument ignores differences among potential bidders — losses associated with the exclusion of some competitors may not be offset by the presence of other bidders exclusion is supposed to induce.

not to be fully realized. In the case of the LECs, government regulation constrains the *exercise* of market power. Moreover, given numerous alternative potential sources of competition, the removal of legal barriers to entry and a new regulatory regime highly favorable to competitive entry, the existence of incentives to make so-called “preemptive” investments appears highly questionable even assuming that regulation is ineffective.

Proponents of limitations on LMDS license eligibility claim that such restrictions produce costless benefits by curtailing the threat of competitive preemption without sacrificing associated efficiencies. We demonstrate that in the case of the LECs the premises underlying the benefit claim are not satisfied. Consequently, regardless of whether there are adverse effects from restrictions in terms of foregone efficiencies, *there can be no net benefits from restricting competition for the LMDS resource rights*. If LEC deployment of LMDS would also yield productive efficiencies, the proposed restrictions would inflict harm on the economy.

Absence of Incentive for Competitive Preemption

Proponents of eligibility restrictions seek to demonstrate that LECs will bid inflated prices for in-region LMDS licenses, and thus preempt competitive entry. To demonstrate the potential for this outcome, they posit the existence of monopoly rents, protection of which creates an alleged incentive to preempt LMDS competition. They then assert that there are no foregone efficiencies from LEC LMDS operations. On this view, the only reason a LEC bid might be successful is the hypothesized benefit from competitive preemption, all other sources of competitive advantage having been ruled out.

The key premise underlying the preemption argument is that *there exists* a monopoly profit stream whose protection warrants a preemptive investment. If there is no monopoly profit stream or it is insufficiently large to warrant the necessary preemptive investment, competitive preemption is a nonproblem. It is a nonproblem because in these circumstances there simply is no incentive to preempt. We note that the economic literature proponents of eligibility restrictions cite is *hypothetical* and simply *assumes* the existence of a monopoly profit stream worth protecting. There are at least three reasons why *even a monopolist* may not possess a monopoly profit stream worth protecting in actual operating circumstances.

First, government regulation of monopoly pricing may effectively constrain the exercise of market power. If government regulation constrains monopoly pricing, monopoly profits will not exist notwithstanding the existence of monopoly. Given reasonably effective government regulation, there is little incentive for LECs to undertake costly preemptive investments to protect monopoly profits which do not exist because they cannot be successfully appropriated.

Second, increasingly effective competition would also operate to dissipate any monopoly profits. Thus to the extent alternative sources of competition exist and can be reasonably expected to become increasingly effective, the expected payoff to any preemptive investment would be attenuated.⁹ Such attenuation would reflect both reductions in the magnitude of potential payoffs and increases in the uncertainty of any payoffs. The likelihood of LEC preemptive investments is thus likely to be reduced, the riskier and less profitable the expected payoffs to such investments.

Third, the preemption hypothesis also presumes that the highest valued use of the resource is expansion of the constrained monopolist's output. If there are higher valued uses, for example, in the production of new, currently unavailable services or expansion of the outputs of other services currently undersupplied, the basis for prevention of preemptive investment fails. In these circumstances, deployment of the resource will be to the highest valued use since the payoff to such deployment exceeds the value of output suppression in the market for the monopolist's output. Prevention of preemption in one market presumably does not justify infringing the freedom of a firm currently operating in a *different* market. Eligibility restrictions of this type may well have the effect of inhibiting a firm's ability to compete in markets in which it is likely to prove a particularly

⁹ In its *Comment* (p. 6), the FTC staff remarks that, "The incentive of a monopolist to outbid a potential entrant for an essential input . . . will be attenuated, perhaps completely, if the monopolist lacks the means to credibly (and profitably) preempt entry. This could occur, for example, if there are no well-defined property rights to the resources required for entry, or if the entrant possesses a technology not possessed by the incumbent." The staff claims that because there would only be one LMDS license in each service area, "there would seem to be considerable risk that anticompetitive entry preemption would be a profitable strategy for incumbent monopolists to pursue." That conclusion is a *non sequitur* as there are actually multiple means available to entrants wishing to compete with incumbent LECs, the technology in question is *itself* not possessed by the incumbent (indeed, as we note presently, the incumbents are, for the most part, not even incumbents in the provision of the services potentially producible with LMDS), and, as we have noted, LECs remain heavily regulated. The FTC staff merely recites theoretical arguments; they fail completely to analyze the single question relevant for gauging the applicability of the theoretical analysis they cite: Do LECs possess the means credibly (*viz.*, *profitably*) to preempt entry? No proponent of license restrictions has demonstrated that LECs actually possess such means. To the contrary, there are ample reasons to support the conclusion that they do not.

effective competitor and in which there is currently less than fully effective competition, *e.g.*, in the case of LECs providing video programming services.

On all three counts, telephone companies appear to be singularly unlikely candidates for license eligibility restrictions based on the existence of incentives to preempt competition. The existence of state and federal regulation suggests that LECs are, at a minimum, significantly constrained in their ability to exercise market power successfully and earn monopoly returns as a result. Major changes in government regulation and the advent of competitive service offerings make the likely success and prudence of a preemption investment strategy highly problematical. At the same time, LMDS license eligibility restrictions may well inhibit LEC efforts to make competitive video service offerings.

Absence of Monopoly Profit Stream: The premise that underpins the argument for license eligibility restrictions is that there is a monopoly profit stream worth protecting. As previously noted, the existence of a monopoly stream is simply assumed in the theoretical literature, but cannot be presumed in real-world applications given the existence of government regulation. Government regulation of the LECs at both the state and federal levels is consciously designed to limit monopoly profits by constraining the level of the prices that may be lawfully charged. At the federal level, LECs are afforded some freedom to increase profitability *if* they can economize and innovate successfully and *if* they commit to *lower* their prices at a rapid rate. Many states operate similar regimes, while others continue to set prices on a traditional basis to afford only a reasonable opportunity to earn a fair rate of return on a specified rate base. Plainly the notion that LECs are able to exercise market power on an unchecked basis is not credible.

If regulation is reasonably effective in limiting monopoly pricing, there is no basis for license eligibility restrictions. Imposition of license eligibility restrictions would imply that the Commission views its own regulation and regulation by the various state public service commissions as ineffective in protecting the public against monopoly pricing. In our view, such a view would not represent an accurate assessment of the effectiveness of current regulation, which clearly operates to constrain monopolistic price increases and limit any monopoly profits.

Likelihood of Increasingly Effective Competition: In addition to effective regulation, the prospects for successful competitive preemption appear likely to be highly ephemeral given the

procompetitive regulatory regime implementing the Telecommunications Act of 1996 as well as the evolution of an increasingly large number of alternative sources of LEC competition. Under terms of the new Act, LEC competitors have been afforded the right to purchase productive input components on an element incremental cost basis and to resell LEC retail offerings at wholesale discounts. Under this regime, the hypothetical ability of LECs to maintain rates at levels significantly in excess of competitive levels will clearly be attenuated even assuming the absence of regulation (itself a counterfactual assumption).

At the same time, there are a large number of likely alternative sources of competition besides the LMDS spectrum. Competition can be expected from a variety of sources: cable system operators reconditioning their networks to permit two-way networked communications, mobile telephone operations (*viz.*, *e.g.*, cellular and PCS),¹⁰ various workgroup wireless offerings based on rationalization of current spectrum assignments, various new satellite-based services, 38 GHz licensees like WinStar, and 18 GHz DEMS licensees like the Associated Group (which just hired Alex Mandl to run its operations in 31 individual markets).¹¹ Obviously a number of operators with substantial financial backing (MFS, Teleport, MCI Metro) are deploying conventional networks and taking advantage of profit opportunities wherever they exist under the current “crazy quilt” of regulated prices.¹² Many new competitors (including AT&T) will be availing themselves of opportunities to compete by purchasing unbundled offerings and reselling LEC retail offerings.

If the face of all these competitive initiatives and a regulatory environment very favorable to competition and effective in preventing monopoly earnings, it is difficult to take the plausibility

¹⁰ The FCC has made available 50 MHz of cellular spectrum and 120 MHz of PCS spectrum. A simple calculation shows that use of modern radio technology with only 60 MHz of spectrum could provide the capacity needed to carry the bulk of the voice telephone traffic in many areas. Assume a technology ten times as efficient as AMPS (*i.e.*, 16 active conversations per MHz per cell site), and assume one-mile-diameter cells. Then, 50 MHz would support $50 \times 16 / \pi \approx 250$ conversations per square mile. If we assume that people use their phones 10 percent of the time in the busy hour, then this configuration would support about 2,500 subscribers per square mile — a high user density. In the real world, there are at least 140 MHz of PCS/cellular spectrum owned by non-LEC affiliates, cells can be smaller than a mile in diameter, and technology is improving.

¹¹ Note well that these radio technologies have been specifically optimized for two-way services to pursue telephony markets.

¹² These firms are building fiber-optic networks to serve areas where businesses are concentrated in many cities and surrounding areas. MCI claims that it already has direct connections to 45 percent of its business customers (MCI President Daniel Akerson quoted in the *Wall Street Journal*, August 27, 1996, p. 1).

of investments in competitive preemption seriously. Such investments are unlikely to occur because they appear likely to prove incapable of producing any net benefits.

Existence of Higher Value Resource Deployments: Heretofore, one motivation for LECs' interest in LMDS has been the desire to find an effective means to offer a competitive video service to customers within their operating regions. Indeed, one of the principal objectives of the new Telecommunications Act was precisely to encourage such competition by removing regulatory barriers to telco provision of video service. No one is arguing that there is anything anticompetitive about a LEC using LMDS to deploy video services. The premise for LMDS license eligibility restrictions on LECs is that the most profitable deployment of LMDS is as a substitute for current LEC monopoly offerings and that, for this reason, LECs possess an incentive to preempt this use of the technology to protect (invisible) monopoly profits.

It is by no means clear that the most profitable deployment of LMDS is as a substitute for current LEC offerings.¹³ There is, as the record in the proceeding and the Commission's own *dicta* disclose, uncertainty about how these operating rights will be most fruitfully exploited in the future. Certainly the Commission's own findings about the absence of effective competition for cable services suggests that one plausible resource deployment would be to offer substitute video services, which the majority of LECs do not currently offer (except on a trial basis).

The argument for license eligibility restrictions assumes that any new services would compete with an incumbent's offerings. But in the case of the LECs, the broadband services that LMDS might provide are largely not offered today via wireline technology.¹⁴ It may be that LMDS constitutes the least-cost method for deployment of such broadband capabilities in a variety of circumstances. The economics of deploying broadband wireline loop capabilities cannot simply be

¹³ For one thing, LMDS may experience difficulties competing for local voice telephony as effectively as PCS and cellular. The Commission's 28 GHz band plan, which restricts subscriber-to-hub transmissions on a portion of the band, makes LMDS less attractive for two-way services, such as voice telephony, and more attractive for broadcast services like video. The equipment to serve the LMDS voice market does not yet exist. Propagation limitations make such equipment much harder to design and build. Meanwhile, PCS and digital cellular system buildouts are proceeding apace. PCS and cellular will soon possess sufficient capacity to meet the entire voice telephone market needs of most major urban areas.

¹⁴ While LECs provide a wide range of local telecommunications services (though generally *not* video service to the home—a service LMDS was specifically engineered to provide), their basic business is voice telephony.

assumed. Proponents of eligibility restrictions presume the economic viability (indeed, the *monopoly profitability*) of broadband wireline loop capabilities, deployed on a widespread basis. Their argument amounts to saying that LECs should not be permitted to compete for a technology because they will be able to preempt competition and protect monopoly profits for services they do not produce with loop technology they have not yet deployed. The LECs may be able to do a lot of things, but earning monopoly profits on services they do not sell is presumably not one of them.

Likelihood of Foregone Efficiencies and Reduced Auction Revenues

Notwithstanding claims by proponents of license restrictions that there are no plausible efficiencies for LEC LMDS operations, the FTC staff (page 9) avers that “it is plausible that scope economies could exist” and that “the issue is entitled to serious consideration.” The FTC staff remarks that the source and magnitude of economies has not been discussed or documented in any detail. While unable or unwilling to state “precisely how much documentation of prospective efficiencies parties should have to supply in a proceeding of this sort,” the Staff nevertheless claims that the responses “do not adequately support” the existence of economies.

We believe it is reasonably likely that LEC deployment of LMDS will yield significant efficiencies and economies that would benefit the public.¹⁵ However, the proof of the scope and magnitude of any efficiencies lies ultimately in their actual realization in the marketplace. Plainly the credibility of beliefs that such economies potentially exist can be expected to be manifest in the bids proffered for LMDS operating rights. The fact that a party can articulate or disclose in an administrative proceeding some basis for a claim regarding the existence (or nonexistence) of economies does not authenticate the genuine existence (or nonexistence) of such economies. Nor, for that matter, does a high bid, although willingness to back ideas with dollars, in our view, certainly constitutes a far more compelling barometer of authenticity and credibility than an

¹⁵ We note that the FCC faced a similar issue with respect to PCS, and concluded that “allowing LECs to participate in PCS may produce significant economies of scope between wireline and PCS networks” (Second Report & Order, ¶ 126). In reaching this conclusion, the FCC recognized that LECs may desire to use PCS to deploy “wireless tails or wireless loops wherever they are more economical than wireline . . . (Second Report & Order, ¶ 113). The potential economies/efficiencies for LMDS are no less significant. In fact, one potential application for LMDS is as a “*broadband wireless loop*,” which would facilitate a less costly alternative for delivering telephony as well as a variety of broadband services (including video) that LECs generally do not offer today.

articulated rationale. Indeed, if articulated rationales are so important, why have the auction? We thought it was precisely the *arbitrariness* of the former that constituted the comparative advantage of the latter.

The FTC staff claims that the types of scope economies cited by the LECs and MSOs are not specific to particular geographic markets. While we regard this characterization as mistaken, we would note that the potential utility (and profitability) of a “one-stop shop” is an idea frequently, indeed ubiquitously, documented in the telecommunications trade press. Carriers like MCI and AT&T have already taken important steps to acquire the capability to offer one-stop shop capabilities embodying both video and various other communication services. Many believe that as the future unfolds new hybrid services will evolve that combine various broadband and interactive communication capabilities. The one-stop shop concept is clearly an idea that has acquired considerable currency and one to which many firms are committing substantial resources.¹⁶

In our view, the prospect of the LECs’ being able to offer customers a combined service offering they would find attractive is highly plausible and it is not at all difficult to rationalize the organizational need for ownership of key component parts for competitive effectiveness. LEC brand names are well known and generally respected within their service regions. LECs often possess specialized knowledge of the specific operating conditions within their service region as well as existing customer contacts. From a technical perspective, certainly one obvious advantage of LMDS is that it can carry a wideband of information (*e.g.*, many television channels). This wideband capability makes it a natural complement to the narrowband channels of the existing telephone network. LMDS may also supply an effective platform for supplying narrowband services (assuming technical disabilities can be overcome). The economic case for building wireline wideband

¹⁶ Baseman (p. 5) remarks that productive efficiencies are not necessarily foregone if they can be efficiently realized via transactions between independent entities. He posits that efficiencies from one-stop shopping might be efficiently realized via a multiplicity of contractual arrangements. However, this theory does not represent market realities, where transactions-cost considerations frequently give rise to economizing arrangements to align incentives properly, to realize productive efficiencies and to rationalize production efficiently.

In this regard, it is significant to observe that both MCI and AT&T have equity participation in their respective video ventures. Perhaps this arrangement is not necessary to achieve venture objectives. But if the existence of this type of integration has organizational significance, it obviously can stand only with difficulty for the proposition that efficiencies can be/are being realized via transactions between independent entities. If anything, these firms’ behavior reveals a belief in the *inefficacy* of arms-length market transactions for organization of the integrated service offerings they wish to make now *and in the future*.

waveguide capability to residences remains unclear. It may well prove the case that the most cost effective approach for a LEC to provide broadband services to many of the homes desiring such service is to combine a narrowband wireline telephone channel with a wideband, one-way wireless channel. In some operating environments, it may make sense to supply both broadband and narrowband services via an LMDS capability. In either guise, LMDS could well provide a productive complement to the existing LEC network.

LOCAL COMPETITION

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Impact of Telecommunications Act of 1996

Industry leaders agree that the 1996 Act and adoption of new interconnection policies will promote the rapid introduction of local services competition.

AT&T Chairman Robert Allen: *New rules "...will provide choice for consumers by making it easier for new competitors to enter the local telephone market". (Press release, 8/1/96).*

MCI Chairman Bert Roberts: *Act "...will usher in a new era of competition in local telephone markets", and "encourage the quick entry of competitors into monopoly local markets by promoting investment and development of a wide range of new, state-of-the-art services". (Press release, 8/1/96).*

MFS Chairman James Crowe: *Commission's order positions MFS "to immediately and aggressively pursue local competitive opportunities". (Press release, 8/1/96).*

Local Competitors

Competition for local telecommunications services will come from a variety of companies, including long distance carriers, competitive access providers, cable system operators, cellular/PCS providers, fixed microwave systems, and satellite-based systems.

AT&T - Full Service Provider

AT&T's Allen Outlines Plans to Enter Local Telephone Market (AT&T press release, 2/8/96).

Plans to offer consumers and businesses in all 50 states innovative packages of local, long distance, wireless, on-line and entertainment services.

AT&T already provides a substantial number of direct connections to business customers. It need only make software adjustments and establish links to local switches in order to allow it to provide local service as well.

Company will also pursue other means to offer local service, including use of cable television and fixed wireless technologies.

AT&T Prepared to "Leap" into Atlantic States Local Service. (AT&T press release, 2/29/96).

Company's applications have been filed and approved in all Bell Atlantic markets as part of plan to offer local service to both residence and business customers throughout the country.

AT&T Signs Alternative Access Agreements with Six Companies. (AT&T press releases, 4/11/96 and 8/26/96).

Pacts will allow business customers in more than 70 major cities to directly connect with AT&T.

Agreements include dedicated and switched local phone service and switched access for business services.

AT&T and DIRECTV Partner for Broadcast Satellite Services. (AT&T press release, 1/22/96).

AT&T also is acquiring an equity interest in DIRECTV. The strategic partnership provides AT&T with a unique home-entertainment service to add to its one-stop shop lineup.

MCI - Full Service Provider

MCI Prepares to Enter Local Phone Market. (MCI press release 8/1/96).

By end of 1996, MCI will have invested \$1 billion in local service initiative, and could spend nearly that much on service in 1997.

Today, company serves local business customers with state-of-the-art fiber optic networks and digital switches in 11 cities. By early 1997, it will offer service in 24 markets in 20 states.

MCI Introduces New Advertising Campaign for Local Service. (MCI press release 8/8/96).

Ads tout a variety of benefits, including volume discounts, customer service, and "an array of communications products and services – all from one company, all on one bill".

Sprint - Full Service Provider

Sprint is one of the three nationwide telecommunications companies offering a variety of local, long distance, wireless, video, and data services. (Sprint 1995 Annual Report).

Company will compete immediately in new local markets.

Sprint Spectrum partnership with three of the nation's largest cable operators establishes Sprint as a major force in wireless and local service markets.

Sprint, Sprint Spectrum, and RadioShack announce a major alliance to provide one-stop shopping for communications services, establishing an unprecedented nationwide distribution channel. (Sprint news release, 9/11/96).

MFS WorldCom - Full Service Provider

MFS and WorldCom, Inc. Announce Merger. (MFS press release, 8/26/96).

Merger "will create one of the world's premier business communications companies, providing a single source for a full range of local, long distance, Internet and international service over an advanced fiber optic network".

MFS Announces New Initiatives Aimed at Capitalizing on Telecom Act. (MFS Press release, 5/7/96).

Company plans to (1) expand the number of U.S. cities served, (2) expand its network in existing cities, (3) construct or acquire its own intercity high capacity network, (4) accelerate central office interconnections, (5) deploy additional switches, and (6) provide high-speed local Internet access.

MFS Signs Co-Carrier Interconnection Agreement with Bell Atlantic. (MFS press release, 7/17/96).

Agreement covers Delaware, the District of Columbia, Maryland, New Jersey, Pennsylvania, and Virginia, and gives MFS the opportunity to accelerate its provision of competitive local telephone services.

MFS Now Offering Local Telephone Services Over Its Own Fiber Network in Baltimore. (MFS press release, 4/1/96).

Company will utilize 100-mile fiber optic network to offer one-stop shopping to medium and small businesses. Services include local telephone service, domestic and international long distance, and a variety of enhanced services – voice mail, calling card, 800/888 number services, customized billing and management.

MFS Granted Full Competitive Local Telephone Exchange Service Authority in Washington, D.C. (MFS press release, 7/30/96).

Order allows MFS to offer a full range of local, facilities-based telephone services over its 500-mile fiber optic network covering D.C. and parts of Northern Virginia and suburban Maryland.

Other Local Competitors

Teleport Communications Group (TCG) set to build on its position as oldest and most experienced competitive local telecommunications provider. (TCG fact sheet).

Company deploying advanced fiber optic networks for transmission of voice, video and data services in a variety of major markets, including New York, Baltimore, Boston, Chicago, Dallas, Detroit, Los Angeles, Northern New Jersey, and Pittsburgh.

Company signs agreement with AT&T to provide businesses with alternative to local carriers' networks.

LCI International plans to provide local service on a resale basis in California, Connecticut, Florida, Georgia, Illinois, Indiana, Maryland, Michigan, New Jersey, New York, Ohio, Pennsylvania, Tennessee, Texas, and Virginia. (LCI news release, 3/27/96).

American Communications Services, Inc. (ACSI) announces construction of networks in four new markets, bringing to 24 the number of networks the company currently has in service or under construction. (ACSI news release, 6/26/96).

100-mile network in Central Maryland will link several Maryland communities in the Baltimore-Washington corridor.

Network will offer businesses and government agencies with local, long distance, and Internet access services.

Cable System Operators

Tele-Communications, Inc. (TCI) offers a single source for diverse advanced communications services including telephony. (TCI Telephony Services Home Page).

Cox Communications offers variety of telecommunications services, including "Alternate Access" which allows businesses to be connected directly to their long distance carrier, bypassing the local phone company's charges. (Cox WWW site).

Company will test the delivery of residential telephone services in San Diego. (Tellabs news release, 4/1/96).

TCI, Cox, Comcast, and Sprint have formed alliance (Sprint Spectrum) to provide an alternative to the Bell companies, offering a wide variety of video and telecommunications services packaged together.. (Cox WWW site).

"Time Warner Cable's Full Service Network is the first in the world to integrate emerging cable, computer, and telephone technologies over a fiber-optic and coaxial cable network". (Time Warner WWW site).

Adelphia Cable Communications will offer local service within its 11-state market in fall of 1996 using Tellabs CABLESPAN technology. (Tellabs news release, 6/5/96).

Cablevision Systems established the first local exchange telephone company owned by a cable system operator; Cablevision Lightpath, Inc. (Cablevision WWW site).

Cable operators take steps to exploit burgeoning data communications market, including Internet access over cable modems. (Cable Datacom News).

Cellular/PCS

“Continued strong growth in cellular, coupled with the introduction of the first broadband PCS network, has stoked the fires for an industry explosion in 1998”. (Dataquest, a unit of Dun Bradstreet Corp.).

Wireless carriers are “seeking to provide a wide range of fixed service offerings to consumers”, including “fixed wireless links to connect residences, apartment buildings, office buildings, and other structures”. (FCC First Report & Order, WT Docket No. 96-6, 8/1/96).

Subscribers will increasingly utilize cellular and PCS phones for making calls that previously would have been made on landline phones. And, many will opt for wireless services as a complete replacement for landline voice services. (“Wireless and Cable Voice Services”. Lawrence K. Vanston and Curt Rogers. Technology Futures, Inc. 1995).

Strategic alliances position big companies as major players in the future wireless marketplace.

MCI agreement with NextWave positions it to be a nationwide provider of wireless services. (MCI news release, 8/26/96).

Sprint Spectrum partnership kicks off the PCS revolution in Washington, D.C. (Sprint Spectrum WWW site).

Fixed Microwave Services

WinStar Communications will use 38 GHz digital wireless links to compete in local markets.

Company plans to offer switched digital services in all of its 41 markets over the next several years. (Lucent news release, 7/29/96).

MCI metro signs deal with WinStar to extend company's local exchange networks. (Telecommunications Reports, 11/20/95).

Associated Communications will use 18 GHz digital wireless links to offer a broad array of communications services to business and residential customers. .
(Associated news release, 8/19/96).

Alex Mandl, former AT&T president, will head company.

Services will include local switched and dedicated telephone service, Internet access, high-speed data and high quality video conferencing.

Satellite-Based Services

Satellite communications will play an increasingly important role in the GII into the 21st century, providing two-way, high-speed video and data networks.

Major players include Hughes, Motorola, Teledesic, Loral/Qualcomm, and TRW.
(Steven Dorfman, Sr. VP, Hughes).

Hughes develops satellite product that will compete with LECs' ISDN services.
(CTIA headlines, WWW).

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News Release

FOR RELEASE THURSDAY, AUGUST 1, 1996

AT&T chairman comments on new FCC interconnection rules

WASHINGTON -- Robert E. Allen, AT&T Chief Executive Officer and Chairman, made the following statement yesterday at a news conference:

AT&T is greatly encouraged by the action the FCC has taken to open local markets to real competition although we're disappointed it has postponed cost-based access reform for up to 10 months. While we haven't seen the full order, the FCC appears to have established rules that, when implemented in partnership with state regulators, will make fair competition in the local telephone business a real possibility for the first time, and ensure that consumers will enjoy broader choice, higher quality and greater value.

The rules outlined today will ultimately provide choice for consumers by making it easier for new competitors to enter the local telephone market. For example, the FCC identified pricing principles that should yield reasonable discounts for resellers of local service. In addition, the rules require a monopoly provider to sell separate elements of its network to new providers at efficient, cost-based rates -- not the bloated, historic costs the local companies wanted. The rules also require that new providers be able to interconnect to the local networks easily and get non-discriminatory electronic access to billing, ordering and maintenance information so they can service customer accounts and that customers be able to keep their phone numbers when switching from the monopoly service. It's notable that these rules are, in most respects, the ones potential competitors have urged the FCC to adopt, that several progressive state regulators have embraced and that we are seeking in our negotiations and arbitrations with the local carriers in the states.

But while the overall framework established by the rules is correct, we're disappointed in the FCC's approach to access fees. The collection of these fees is nothing more than an unjustified 'tribute' to the local companies and is contrary to the Telecom Act's central purpose of requiring cost-based prices. It's particularly outrageous that during a transition period, the local companies will continue to collect access fees from new entrants who buy unbundled network elements, even when the local companies no longer provide any service to the new entrants' customers.

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