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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

October 2, 1996

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 96-149, Non-structural Safeguards - Section 272 of the Communications Act*

Yesterday, Marlin Ard, Deputy General Counsel, Pacific Telesis, Jerry A. Hausman, MacDonald Professor of Economics at the Massachusetts Institute of Technology, and I met with Joseph Farrell, Chief Economist, Office of Plans and Policy and Gregory Rosston, Chief Economist, Common Carrier Bureau, to discuss issues reflected in Attachments A and B. Mr. Ard, Mr. Hausman, Michael J. Yourshaw of Wiley, Rein and Fielding, and I met with Regina Keeney, Chief, and A. Richard Metzger, Jr., Deputy Chief, Laurence Atlas, Associate Bureau Chief, Common Carrier Bureau, Donald K. Stockdale, Deputy Chief, and Patrick Degraba and Linda I. Kinney, Policy Division, Common Carrier Bureau, to discuss issues reflected in Attachment A. Please associate this material with the above referenced proceeding.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules. Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Attachments A and B

cc: Laurence Atlas
Patrick Degraba
Joseph Farrell
Regina Keeney
Linda I. Kinney
Richard Metzger
Gregory Rosston
Donald Stockdale

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CC Docket No. 96-149 Ex Parte

- Joint Marketing
- Centralized Administrative Services
- Nondominant Regulation

Intent of Congress in Passing the Telecommunications Act of 1996

"... 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 by opening all telecommunications markets to competition."*

To Meet Congress' "Pro-Competitive, De-Regulatory" Goals the Commission Should Not Handicap PBCOM

- Pacific Bell and PBCOM can offer one-stop shopping
- Pacific Telesis can provide administrative services for PBCOM
- PBCOM must be regulated as a nondominant carrier

JOINT MARKETING — SECTION 272(g)(1)&(2)

- The Act permits PBCOM to market intraLATA and interLATA services
- The Act permits Pacific Bell to serve as a sales channel for its interLATA affiliate, PBCOM
- Pacific Bell will meet its equal access obligations for all interexchange carriers
- Pacific Bell and PBCOM can offer one-stop shopping
- PBCOM will fairly compensate Pacific Bell for all joint marketing efforts

PBCOM Plans To Market IntraLATA and InterLATA Services

- PBCOM currently plans to resell local services of its affiliates, Pacific Bell and Nevada Bell, as well as of selected other incumbent LECs
- PBCOM currently plans to resell Sprint interLATA service when Section 271 authorization is received
- Will sell through a variety of channels
  - its own marketing force
  - third party retail channels
  - Pacific Bell/Nevada Bell joint marketing

The Act Permits Pacific Bell To Serve As a Sales Channel for Its InterLATA Affiliate, PBCOM

- Includes all marketing and sales-related activities
- Pacific Bell will comply with all CPNI requirements in marketing PBCOM services
- Marketing and sales include, for example:
  - advertising
  - outbound calling to customers
  - offering both types of services on the same call
  - packaging and bundling services together

Pacific Bell Will Meet Its Equal Access Obligations for All Interexchange Carriers

- On “inbound” customer inquiries about a new service connection or change in local exchange access service, Pacific Bell will
  - inform customers that they have a choice of many interexchange carriers for long distance services
  - offer to read from a “revolving” list of available IECs
  - describe PBCOM’s services, prices, terms and conditions
  - place the order for PBCOM or other IEC’s service

Pacific Bell Marketing of PBCOM Services

- On "inbound" calls where a customer requests or inquires about PBCOM service, Pacific Bell will discuss PBCOM's services with the customer and may place the order
- On "outbound" calls (where Pacific Bell contacts a customer) Pacific Bell will actively solicit orders for PBCOM's services

Pacific Bell and PBCOM Can Offer One-Stop Shopping

- This is essential to compete with other IECs that offer bundled services
- Promotes competition — as the Act intends
- Minimizes customer confusion from multiple contacts
- Increases economic efficiency — permits economies of scope

PBCOM Will Fairly Compensate Pacific Bell for All Joint Marketing Efforts

- Terms of compensation will be consistent with federal and state affiliate transaction rules
  - Must be publicly filed and will be closely scrutinized by interested parties
- Subject to various audits — Commission(s), company auditors, and external auditors
- Requirement to maintain separate books will enable detection of inequities

PROVISION OF ADMINISTRATIVE SERVICES BY THE HOLDING COMPANY

- Consolidation of administrative services can benefit consumers
- Section 272(b) does not apply to the holding company
- The provisions of the 1996 Act are sufficient to preclude cross-subsidy and discrimination

Consolidation of Administrative Services Can Benefit Consumers

The holding company or a service subsidiary can perform certain functions for all of its subsidiaries, including the BOC and a section 272 separate affiliate

- Finance and Accounting
- Legal Services
- Human Resources
- Marketing Communications
- Research and Development
- New Product Development
- Certain Procurement
- Management Information and Marketing Support Systems
- Real Estate Management
- Business Placement

By consolidating administrative services the corporation can realize economies of scope and scale and benefit consumers

Section 272(b) Does Not Apply to the Holding Company

- The four structural separation provisions of section 272(b) expressly relate only to the relationship between the separate affiliate (PBCOM) and the Bell Operating Company
- If Congress had intended to separate the Holding Company, it would have been specific
- The central provision of administrative services is essential to efficient operations
- PBCOM's competitors, such as AT&T and MCI, are permitted to provide centralized administrative services
- Under *Computer Inquiry II*, even the BOC was permitted to provide certain "administrative services" for the separate affiliate

The Provisions of the 1996 Act Are Sufficient To Preclude Cross-Subsidy and Discrimination

- Pacific Bell's books, records, and accounts are separate from PBCOM's
- Pacific Bell and PBCOM will have separate personnel
  - Obtaining services from the same company does not create shared employees
- Pacific Bell's assets will not guarantee PBCOM's credit
  - Any holding company guarantee of the affiliate's debt must be without recourse to the BOC's assets
- Transactions between Pacific Bell and PBCOM must be at arm's length and will be subject to the Commission's affiliate transactions accounting rules

PBCOM MUST BE REGULATED AS A NONDOMINANT CARRIER

- PBCOM has no market power
- Dominant regulation will harm competition
- The U.S. Department of Justice recommends: *"The Commission should not apply its dominant carrier regulations to BOC affiliates."*

PBCOM Has No Market Power To Raise Prices by Restricting Its Own Output

- PBCOM has zero initial market share for interstate, domestic (or international) interLATA telecommunications services
  - It cannot quickly increase its market share to the point where it could raise prices by restricting output because it will be competing with large, established carriers like AT&T and MCI
- Substitutable supply capacity exists — customers can easily change providers if PBCOM's prices are not competitive
- PBCOM would not have market power under any narrower market definition

PBCOM Has No Market Power To Raise Prices by Raising Rivals' Costs

- Pacific Bell cannot exercise any "bottleneck" control
  - The Commission has determined that the Act allows competitors to provide exchange access using unbundled network elements, shattering the "bottleneck" and any competitive advantage
  - Pacific Bell must provide exactly the same treatment to CLECs that it provides to itself
- Pacific Bell's local exchange services and facilities are price controlled, precluding exercise of market power
  - Exchange access is subject to price caps
  - Unbundled elements must be priced at TELRIC

Cost Misallocation, Predation, or Discrimination Cannot Be Used To Gain Market Power

- The Act's structural and accounting safeguards prevent cost misallocation and cross-subsidies
- Predation cannot be successful
  - The low marginal cost of interLATA traffic would lead to huge financial losses by a would-be predator
  - Because of the substantial sunk cost in competitors' existing networks, there is no barrier to market re-entry
- Competition cannot be distorted by discrimination
  - Discrimination cannot be effective and undetectable at the same time
  - The Act's specific nondiscrimination safeguards will be effective

Dominant Regulation Will Harm Competition

- Tariffs filed on 1 day's notice — like PBCOM's competitors
  - Enables PBCOM to match price changes of its competitors over an identical time period
  - Speeds new services to customers
  - Longer notice periods could harm consumers by reducing price discounts and other forms of price competition among incumbent long distance carriers
- No cost support — like PBCOM's competitors
  - PBCOM will compete in markets the Commission has already declared competitive — PBCOM should not be required to disclose its costs to its competitors

Dominant Regulation Will Harm Competition

- No 214 approval process — like PBCOM's competitors
  - The streamlined 214 process allows rapid introduction of new services
- No price cap regulation — like PBCOM's competitors
  - Price cap regulation of PBCOM would interfere with market pricing and result in less efficient investment and service decisions

SUMMARY

- Pacific Bell and PBCOM can offer one-stop shopping
- Pacific Telesis can provide administrative services for PBCOM
- PBCOM must be regulated as a nondominant carrier

Statement of Professor Jerry A. Hausman

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

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

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

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

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

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

I. Summary and Conclusions

6. Dominant regulation is designed to ameliorate market power that

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

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

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

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

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