relief were granted. Consequently, if quality discrimination were to occur, we would expect it in those areas where Sprint is an integrated provider of access and interexchange services. However, no complaints of discrimination have been raised by the other IXCs.

47. Other local exchange carriers such as GTE, Frontier, and SNET have recently expanded *de novo* into long distance service, and the evidence to date does not indicate that these LECs have acted to manipulate quality to reduce competition in the long distance market. As conclusively proving the non-existence of discrimination requires extensive data collection, we conducted a limited survey of the New York and Connecticut public utility commissions, and found that, to date, there have not been any complaints filed by IXCs alleging quality discrimination on the part of Frontier or SNET in the provision of access.[39]

48. Chile provides an illustrative example, for, as the chairman of this Commission said, its experience "tells the great tale of social and economic benefits [of long distance competition]."[40] Before the mid-1994 liberalization, ENTEL, a separate firm, controlled Chile's long distance market, carrying approximately 90% of long distance traffic. Despite the fact that Compañia Telefonos de Chile (CTC) controls over 90% of access lines in Chile,[41] CTC was allowed to enter the long distance business at liberalization, at the same time as all other entrants. CTC was required to provide long distance through a separate subsidiary, and was limited to 35 percent of the domestic long distance market through mid-1995, increasing to 45 percent in 1996, 55 percent in 1997 and 60 percent in 1998. Although CTC is also required to provide non-discriminatory interconnection at regulated rates, it is not subject to unbundling or resale requirements, nor is it under the same degree of scrutiny by the Chilean regulatory authorities as

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39 Telephone interviews with Linda Voss of the New York Public Service Department, December 17th and 18th, 1996, and Nadine Wenz of the Connecticut PUC, December 13th and 16th, 1996.

40 Remarks of Reed Hundt, reported in *Washington Telecom Newswire*, December 3, 1996.

41 Flemings Research. Cia. De Telecomunicaciones de Chile (CTC) Company Report, January, 1996.

are the RBOCs by the FCC and state commissions.[42] Therefore, if there is a real prospect of quality discrimination once a monopolistic LEC is allowed to provide long distance, we would expect CTC to engage in such behavior. On the contrary, the "telecommunications market in Chile is booming,"[43] and there is no evidence of discrimination by CTC in favor of its long distance affiliate.

49. New Zealand and the United Kingdom are further examples where there appears to be vigorous competition in the long distance market despite the presence of vertically integrated local exchange providers. The UK provides a particularly interesting parallel, where the incumbent local exchange company's (British Telecommunications - "BT") revenue shares of the residential and business long distance segments were 88% and 73% respectively.[44] We further note that the competitive safeguards placed on BT are much less onerous than those placed on Ameritech and its long distance affiliate: BT is not required to provide its residential customers with "equal access;"[45] nor is it required to unbundle loops or switching functions; nor is its long distance subsidiary required to file formal imputation tests. Nevertheless, MCI, an opponent of Ameritech's entry into long-distance in the US, attests its belief that "BT's UK operations are governed by a broad array of UK and EC competitive safeguards that limit BT's ability to engage in 'anti-competitive practices' and ... prevent BT from acting anti-competitively."[46] If this is the

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42 For example, CTC's local exchange prices are still under full rate-of-return regulation. See Oliver Stehmann, "Network Liberalization in Developing Countries: the Case of Chile," *Telecommunications Policy*, Vol. 19 No. 9, 1995, pp.667-684.

43 "Chile's Telecommunications Market," in *A Guide to Telecommunications Markets in Latin America and the Caribbean*, ITA, June 1996.

44 OFTEL, *Market Information Update,* Director General of the Office of Telecommunications, London, October 1996, at 14, 16.

45 Instead of offering the equivalent to the US "presubscribed interexchange carrier," BT requires its customers to employ "indirect access ... the use of a 3-digit carrier code or a 'smart button' to access a long-distance provider other than that [selected] by the local telephone operator." See Application and Notification by MCI Communications and British Telecommunications in the Matter of the Merger of MCI Communications and British Telecommunications, filed before the FCC, December 2, 1996, at p. 42 n. 110.

46 Application and Notification by MCI Communications et. al., *ibid.*, at 44, 51.

case in the UK, it must be even more so in the US, where the regulatory agencies enforce more detailed and stringent rules more vigorously, where both the antitrust and regulatory authorities are more vigilant, and especially when the local exchange company would be a *de novo* entrant into long distance.

50. In conclusion, the actual experience of US local exchange carriers that are vertically integrated into long distance does not appear to have been associated with discrimination or reduced competition in the long distance market. Further, the experience of other countries suggests that vertical integration between local exchange and long distance is consistent with vigorous long distance competition.

B. Wireless

51. The provision of cellular service is another situation in which potential exists for quality discrimination by the LEC to favor its separate cellular affiliate. The LEC must provide interconnection to the local exchange network, and often provides the transport to and from the competitor's cell sites, switch, and points of presence of various IXCs. However, the rapid growth of the non-wireline cellular operator in the Detroit-Ann Arbor MSA[47] indicates that Ameritech has not abused its control of the wireline network to favor its cellular affiliate.[48]

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47 Jointly owned by Airtouch (50%) and Cellular Communications Inc. (50%), the non-wireline operator in the Detroit-Ann Arbor MSA operates under the brand name CellularOne. See Donaldson, Lufkin & Jenrette, *The Wireless Communications Industry*, Winter 95-96, p. 58.

48 Ameritech owns 95.4% of the wireline operator, the balance is owned by Century Telephone (3.2%) and Cel-Ten L.P. (1.4%). See *The Wireless Communications Industry*, *op. cit.*

52. As of June 1993, the Ameritech affiliate had a substantially larger market share compared to its Airtouch/CCI competitor in the Detroit MSA, where they had 226,000 and 133,000 subscribers respectively.[49] However, by 1994 the two carriers had roughly equal shares, with an estimated 266,000 subscribers each.[50] If Ameritech had been discriminating effectively, it would be unlikely that Airtouch/CCI would have been able to equalize its share with Ameritech.

53. Further evidence of the lack of discrimination in cellular by LECs comes from Schmalensee's study results that the wireline cellular operator's market share is not affected by whether the operator is owned or affiliated with the incumbent LEC in that market.[51] Another study by Reiffen et. al.,[52] finds that "cellular prices are higher in markets where the LEC owns a larger share of the equity in one of the cellular companies and owns a larger portion of the relevant physical assets."[53] However, they report that "increases in quality [due to increased presence of the incumbent LEC] seems to have increased welfare more than the higher price decreased it."[54] These results are inconclusive, as they test for higher prices in cellular markets with LEC ownership, rather than direct observation on the quality of interconnection, and because of general methodological shortcomings of the study (important regulatory variables that have been shown by Hausman[55] and Shew[56] to influence price and quantity were omitted, so that

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49 "The RCR Top 20 Cellular Markets," *Radio Communications Report*, June 21, 1993, p. 10.

50 "The RCR Top 40 Cellular Markets," *Radio Communications Report*, May 9, 1994, p. 12.

51 Affidavit of Richard Schmalensee, Motion of Bell Atlantic Corp, BellSouth Corp., Nynex Corp., and Southwestern Bell Corp., to Vacate the Decree. Civil Action No. 82-0192 (HHG), Mar. 10, 1994, pp. 20-23.

52 David Reiffen, Laurence Schurmann, and Michael R. Ward, "Is Local Exchange Interconnection Discriminatory?" Nov. 1996.

53 Ibid. p. 23.

54 Ibid.

55 Affidavit of Jerry A. Hausman on behalf of CTIA, filed in the matter of the Petition of the People of the State of California and the Public Utilities Commission of the State of California To Retain Regulatory Authority over Intrastate Cellular Service Rates, FCC PR Docket No. 94-105.

the study did not account for the influence of price on quantity; many variables had insignificant effects or opposite signs).

54. To develop further evidence on this issue, we updated Schmalensee's analysis cited above with more recent data, combining it with the elements from the Hausman and Shew studies also cited. Looking at the US's 40 largest cellular markets, we examined whether ownership by the dominant LEC of either the A or B cellular operator affected total market output, after controlling for the endogeneity of price. Our results, reported in the attached Exhibit 1, do not support the hypothesis that LEC ownership of cellular affiliates results in an overall decrease in cellular subscribership (output). Such a decrease would be a necessary, but not sufficient, finding to reach the conclusion that LEC affiliation decreases cellular competition through discrimination, and therefore leads to less output at higher prices.

C. IntraLATA toll

55. Currently, Ameritech encounters competition, largely from the IXCs, in the provision of intraLATA (or local toll) service, and it is not required to provide this service through a separate subsidiary. As the provision of intraLATA interexchange service is the same as interLATA interexchange service, one might expect that if quality discrimination against the IXCs were possible, it would occur for the provision of intraLATA service. As of May 1995, competitors of Ameritech had secured 34.1% percent of all intraLATA toll revenues from medium and large businesses within the Detroit LATA that were surveyed by Quality Strategies. Such loss of market share is tangible evidence that Ameritech has not behaved in an anti-competitive manner. Moreover, these market share losses had occurred before the beginning of intraLATA toll dialing parity implementation.[57] In January 1996, AT&T and other IXCs

[56] William B. Shew, "Regulation, Competition, and Prices in Cellular Telephony." Working paper prepared for The American Enterprise Institute for Public Policy Research, Jun. 2, 1994.

[57] Without intraLATA toll dialing parity market share losses are primarily from the use of dedicated facilities or customer dial-around.

began offering pre-subscribed intraLATA service to certain Michigan exchanges. As a result, by November 1996, Ameritech had experienced a loss of 81,000 residential toll customers, or 27% of the total Ameritech Michigan residential customers with intraLATA dialing parity.[58] This rapid growth of competitors' intraLATA toll shares is difficult to reconcile with hypotheses of discrimination.

D. Information services

56. Ameritech has offered information services since the MFJ ban was lifted in 1991. To the present time, no federal or state regulatory agency has found the company to have engaged in anti-competitive behavior. If Ameritech were harboring a plan to unfairly use its local network to undermine competition in a downstream market, information services offers an opportunity for the company to proceed. For intraLATA information services provided in the Ameritech region, Ameritech access facilities play an integral role in every transaction. Anti-competitive tactics of Ameritech, if technologically feasible, could dramatically influence the quality of a competitor's service. However, no evidence of anti-competitive behavior exists.

57. Ameritech is allowed to operate an information service as part of the same entity providing local exchange service. There is no separate corporate entity, and both costs and personnel are shared. Yet, there have been no allegations of anti-competitive behavior.

58. In sum, any presumed anti-competitive behavior associated with the requested interLATA authority would be effective as part of Ameritech's strategy in intraLATA information services. The fact that the company has not attempted any such behavior lends considerable support to the conclusions presented herein, the efficacy of existing regulatory

[58] Affidavit of Jason Few on behalf of Ameritech, in *Ameritech Michigan v. Michigan Public Service Commission*, Michigan Court of Appeals No. 198706, MPSC Case U-10138.

safeguards, and the predisposition of Ameritech to compete properly in the telecommunications business.

E. 800 number services and WATS

59. The account is no different when the focus switches to WATS and 800 services. Between 1990 and 1995, Ameritech's WATS and 800 service revenues declined 48.5%.[59] In the growing market for 800 service[60] Ameritech's revenues declined by 53% percent over the same period.[61] Ameritech lost revenues to IXCs who were able to attract away its customers by offering integrated intraLATA and interLATA 800 and WATS services. Again, if Ameritech has an incentive to use its position in the local exchange to disadvantage competitors in other service areas, it would have employed such a strategy to stem the rapid erosion of its share of WATS and 800 number services. Lacking evidence of such discrimination, the only rational and legitimate explanation is that the company, through the forces of competition, regulation, or a combination of both, lacks the incentives and abilities needed to attempt and successfully implement anti-competitive stratagems.

F. Empirical evidence from vertical integration in other industries

60. As the cable television industry was recently regulated,[62] its experience can cast light on the applicability of "one monopoly rent" theories to vertical integration in regulated

59 Calculated from Form M and ARMIS Data.

60 Northern Business Information estimates that 800 service revenues will grow consistently from 1992 to 1997 with a compounded annual growth rate of 6.2 percent. Northern Business Information, U.S. Telecom Service Markets: 800 Portability, August 1993.

61 Calculated from ARMIS Data. According to a May 1995 study conducted by Quality Strategies on Ameritech's behalf, Ameritech's shares of the intraLATA 800 revenues in Detroit and Grand Rapids were 5.2% and 5.4% respectively.

62 The 1992 Cable Act allowed the FCC to regulate basic service rates charged by cable operators not facing "effective competition." The Act defined "systems facing effective competition" as systems with low penetration, or which were at least partially overbuilt by a competing cable system. See *Cable Television*

industries. Most cable operators supply "basic service" under conditions of substantial market power. Cable operators also offer additional "premium" satellite delivered channels, such as HBO or Showtime, which can be purchased individually, but must be purchased in conjunction with basic service. The FCC gradually tightened rates for basic service but not those for premium channels, which face competition from other media, such as movies and video rentals. Therefore, given that there is considerable integration between these cable systems operators and premium channels provision,[63] the theory advanced by opponents of RBOC entry into long distance would predict increasing prices for the downstream activity, provision of premium channels, by the vertically integrated upstream monopolists as a consequence of increased basic programming regulation.

61. To empirically test this theory, we examined whether the increased regulation between 1994 and 1996 resulted in an inflation-adjusted change in end-user prices charged in 1994 and 1996 by the country's 25 largest cable systems for provision of HBO, the leading premium service in the US. Our results are shown in the attached Exhibit 2. We do not find a statistically significant increase in the end-user price of HBO, which is what would be expected if competition in the downstream market had been significantly affected. We therefore conclude that, in the cable television industry, vertical integration on the part of an upstream regulated monopolist has not reduced the competitiveness of the downstream market.

G. Conclusion

62. In sum, Ameritech's evidence of past behavior, in wireless, intraLATA toll, information services, 800 number services and WATS, is consistent: regulatory safeguards and

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Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385. The recent Telecommunications Act of 1996 requires these rate regulations to be phased out by 1999.

63 The leading premium channel providers such as HBO, Cinemax, and Encore are owned or controlled by leading cable multiple systems operators (MSOs). See FCC *Second Annual Report in the Matter of the Status of Competition in the Market for the Delivery of Video Programming*, CS Docket No. 95-61, released December 11, 1995.

competitive conditions have succeeded in precluding any discrimination by Ameritech. Opponents of Ameritech's interLATA application cite the Bell System discrimination in long distance prior to divestiture in support of their theories. However, even a cursory understanding of regulatory history establishes that the mandate which AT&T believed it had from regulators is quite different from the missions and mandates which the RBOCs and AT&T have today. In short, it is not proper to project AT&T's pre-divestiture behavior – where AT&T often acted as if it believed it was required to thwart new entry in order to safeguard the integrity of the network and to support a system of cross-subsidies imposed by regulators – onto Ameritech.

VII. Entry of Ameritech into Long Distance Service is Unlikely to Cause Undesirable Regulatory Distortions

63. A common critique made by opponents to LEC entry into long distance is that the LEC will have an incentive to cross-subsidize its long distance operation, and shift costs onto regulated services, such as local exchange service. Even if there were such incentives, they are not fundamentally different from the incentives that a regulated firm has to cross-subsidize any competitive activity. To the extent that Ameritech diversifies into competitive activities such as real estate, there is a risk that costs will be shifted out of these competitive activities and into regulated local exchange services. Regulators are familiar with these risks and can deal with them with cost allocation rules, cost reviews, price floors and imputation tests. Moreover, economic studies show that local exchange services tend to be priced below economically efficient levels in some cases. Thus the "risk" is that prices for local services may increase somewhat to a level closer to their actual costs.

A. The role of price-cap regulation

64. Most importantly, however, in Ameritech's case, price cap regulation is so pervasive that few incentives, if any, remain, to cross-subsidize competitive services. For example, as

demonstrated in the Wilk and Fetter Affidavit,[64] all of Ameritech Michigan's regulated services have been under price cap regulation since 1991, as a result of the initial 1991 Michigan Telecommunications Act, and will remain under price caps after the current rebalancing of rates for basic services required by the current Michigan Telecommunications Act.[65] Note that this prospective rebalancing is not governed by whether Ameritech Michigan is earning adequate rates of return on its investment, but instead by the Commission's estimate of Ameritech's total service long run incremental costs, calculated in a forward looking manner without considering the existing investment in network assets. Once these rebalanced rates are set, they will be under price cap regulation. The price cap regulation, under which Ameritech Michigan will be regulated, is the single most important safeguard against cross-subsidization, as it cuts ties to cost regulation.[66]

65. Ameritech's interstate access services are governed by a single price cap with multiple baskets administered by the Commission. From the three available options, Ameritech has selected pure price regulation for its interstate services under FCC jurisdiction,[67] and elected to immediately lower prices in return for the lifting of the earnings sharing requirement. Thus, Ameritech's voluntary choice eliminates the incentive for Ameritech to shift costs onto the federal-jurisdiction price-capped services.

66. In short, price cap regulation without profit sharing, which is the current status at both the state and federal level, greatly reduces incentives for Ameritech to subsidize its interLATA offerings with supracompetitive pricing in non-competitive services. One of the two

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64 Affidavit of Mitchell Wilk and Steven Fetter in this application.

65 1991 Public Act 179, as amended by 1996 Public Act 216.

66 Because it divorces prices from costs, price cap regulation eliminates the regulated firm's incentive to cross-subsidize. See Timothy J. Brennan, "Regulating By Capping Prices," in *Price Caps And Incentive Regulation In Telecommunications*, Kluwer Academic Publishers, 1990, p. 41.

67 Wilk-Fetter Affidavit, *op. cit.*.

major concerns which motivated the quarantine has been reduced due to the fact that rate of return regulation for Ameritech Michigan has been phased out.

B. Access charges and imputation tests

67. Opponents of RBOC entry into long-distance contend that the RBOC affiliates will be able to compete "unfairly" against IXCs, as the affiliate will consider access charges as a mere transfer payment, while they represent a "hard cost" for the IXCs, and the outcome is therefore anti-competitive. [68] This is wrong, as the services provided by Ameritech's long distance affiliate will be subject to imputation tests designed to enforce the requirement that the transactions between Ameritech and its long-distance affiliate will be carried out at an "arm's length" basis at non-discriminatory prices. Hence, the price of the service must recover the service's incremental costs to the affiliate plus the costs of the access self-supplied by Ameritech, imputed at a non-discriminatory price.

VIII. COMPETITION WILL FURTHER LIMIT THE ABILITY OF AMERITECH TO DISCRIMINATE AGAINST COMPETING LONG DISTANCE CARRIERS

68. Ameritech faces increasing competition in the provision of access services to IXCs, as well as significant future competition in the provision of integrated telecommunication services once interLATA authority is granted. Additionally, the provisions of the 1996 Telecommunications Act, requiring Ameritech to provide unbundled network elements to existing and potential local competitors, make opportunistic entry easy – the entrants need only incur minimal sunk costs. These three factors, combined with the fact that telecommunications revenue in Michigan is highly concentrated, mean that hypothetical discrimination by Ameritech would enhance profit opportunities for its existing and future competitors, which comprise both

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68 B. Douglas Bernheim and Robert D. Willig, "The Scope of Competition in Telecommunications." Working paper prepared for the American Enterprise Institute for Public Policy Research, Oct. 25, 1996.

competitive access providers and competitive local carriers. Consequently, any hypothetical discrimination by Ameritech is likely to generate revenue losses in the local exchange business, making such discrimination less likely. Below we explore the four factors that make competition a disciplining device in greater detail.

A. Concentration of Telecommunications Revenues

69. Because demand for telephone services is neither homogenous nor equally distributed across customers, classes of service, or geographical areas, revenues from telecommunications services are highly concentrated. In addition, the density of customers varies dramatically across space: that is, the most intensive customers tend to be highly geographically concentrated. Thus, the hypothetical discrimination postulated by Bernheim and Willig[69] would put a substantial amount of revenue at risk to selective entry even if only a small percentage of Ameritech's major customers switched to other service providers.

70. Bernheim and Willig acknowledge that this competition will discourage RBOCs from attempting to degrade the quality of originating access.[70] They claim, however, that it will not prevent RBOCs from degrading the quality of terminating access, because consumers at the receiving end of a call cannot choose the access provider for calls that terminate on a RBOC's network. However, as fully explained in the Kocher affidavit and summarized above, the existing technology and automated provisioning systems do not allow Ameritech to selectively degrade the quality of terminating access for competing IXCs, while simultaneously providing high quality service for terminating calls that use the its long distance affiliate, without engaging in an extensive and easily detectable conspiracy.

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69 Bernheim and Willig, "The Scope of Competition in Telecommunications," *op. cit.*

70 *Ibid.*

B. Ameritech's large customers already have alternative access providers

71. As explained in affidavits by Harris and Teece,[71] and by Gregory Dunny,[72] Ameritech faces competition today from competitive access providers, particularly for traffic that originates in its territory from large volume consumers of telecommunications services, and will face additional competition in the near future from integrated service providers, alternative local exchange carriers, wireless carriers, and CAPs. Competitive local exchange carriers (CLECs) and access providers have experienced large revenue growth, have expanded aggressively, and are well poised to capitalize on any opportunities that would be opened by discrimination on Ameritech's part. Ameritech estimates that, as of December 1996, CAPs' and CLECs' market share for DS-1 service is 14% in Detroit and suburbs, and 48% in Grand Rapids, and that there is continued erosion of Ameritech's market position.[73] The buying power of IXCs, plus competition from CAPs, has led Ameritech to aggressively respond to its competitors' successes, lowering its prices dramatically to prevent even faster loss of customers and revenue. Since 1991, for example, the price of a DS1 line in downtown Detroit from Michigan Bell has fallen by 36%.[74]

72. Ameritech has economic incentives to provide competitive, high quality access services, that override any incentive to discriminate against competitors. Competition for access revenues will force Ameritech to maintain high quality access services, because attempts by Ameritech to degrade the quality of originating access would likely result in large losses of access revenues as large volume customers would turn to alternative access providers. For the foreseeable future, the main source of Ameritech's long distance-related revenues will come from the provision of access services to IXCs. It would be foolhardy for Ameritech to engage in

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71 Affidavit of Robert G. Harris and David J.Teece in this application, hereafter Harris-Teece Affidavit.

72 Affidavit of Gregory Dunny in this application, hereafter Dunny Affidavit.

73 Testimony of Richard H. Gilbert, Jr., on behalf of Ameritech, in *AT&T Michigan v. Ameritech.*

74 Calculated from historical Ameritech DS1 data.

activities that would encourage IXCs to turn to alternative access providers, either for originating access or terminating access or both. The cost to Ameritech Michigan in foregone access revenues would be enormous, as even a loss of 5% of access revenues amounts to $20.7 million.

73. The economic rationale for Ameritech to continue providing high quality access even when its affiliate is competing downstream has been discussed by David Sibley and Dennis Weisman.[75] They show that under plausible assumptions, the incentive to maintain access quality for the downstream competitors (to sustain access volume and hence the profitability of the access business, because access charges exceed the short-run marginal cost of providing access) dominates the incentive to reduce quality (to increase volume and hence profitability of the downstream affiliate). Furthermore, Sibley and Weisman show that the incentive to maintain quality is related to the intensity of competition in the downstream market, and that the incentive to discriminate upstream is linked to the existence of monopolistic profits downstream. Therefore, to the extent that Ameritech's entry in interLATA service increases competition in the downstream market, it will also tend to reduce whatever incentives may be present to discriminate in the provision of access. It must also be noted that Sibley and Weisman do not consider the possibility of the upstream firm losing part of the profitable access business as the result of its discrimination. Clearly, when this impact is considered, the overall incentive to maintain quality is strengthened.

74. It is also important to recognize that Ameritech depends not only on revenues earned by providing IXCs access to its local network, but also on IXCs to provide bulk long distance service for resale. Therefore, although Ameritech has currently contracted for bulk long distance with WorldCom, it would risk retaliation when negotiating the next contract if it were to act to discriminate against long distance carriers today, retaliation which can take the form either of

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[75] Sibley and Weisman (1995), *op. cit.*

refusal to provide services for resale (or a higher price for resale) or a reduction in the demand for access service.

C. Existing and potential local competition will serve to discipline access markets.

75. The best argument for the importance of entry conditions in disciplining the telecommunications market is the actual evidence that it works. This evidence is amply provided by considering the experience in switched access. As reported in the Harris-Teece Affidavit[76] and discussed above, CAPs have made substantial inroads into the access market. The large capital investments of CAPs indicates their commitment and their belief that local exchange services offer significant economic opportunities.

76. Harris and Teece also report that a large number of established IXCs and CAPs have obtained local service certification, and several are already providing service.[77] The major interexchange carriers will bring large investments of financial and human capital to the local exchange playing field. For example, AT&T already has a large sales force coverage and frequent account contact with Ameritech customers. MCI, Brooks Fiber, MFS, and TCG have all deployed advanced class 5 switches in Michigan. MCI, TCG and MFS respectively have two, one, and two switches in the Detroit area, while Brooks Fiber's switch is located in Grand Rapids.[78]

77. Wireless, CATV and alliances combining various telecommunications services are positioning themselves to provide new and innovative services to the local market. The respective infrastructures and competitive advantages of CAPs, cable companies, IXCs and

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76 Harris-Teece Affidavit, *op. cit.*

77 Harris-Teece Affidavit, *op. cit.*

78 Harris-Teece Affidavit, *op. cit.*

cellular carriers provide opportunities for numerous ventures and alliances.[79] Alliances like Sprint Spectrum allow Sprint access to extensive cable fiber and subscriber bases. AT&T recently signed an agreement with Teleport which covers Detroit (and 8 other cities), under which it will use Teleport's network to access customers, thereby bypassing Ameritech's network and avoiding access charges.[80] A significant benefit to such alliances is that IXCs can challenge Ameritech's local business without building their own facilities.

78. Given the terms of interconnection arbitrations that have recently concluded in Michigan, and the pro-competitive regulatory frameworks endorsed by the Michigan Public Service Commission in its arbitration decisions, conditions for future entry are highly conducive to a growing wave of competitive entry. Put differently, new entrants can discipline a market even though they account for a small percentage of the total market. This is clear evidence that policy makers should focus on entry conditions, not market concentration, when assessing whether an incumbent firm has market power.

D. The role of easy entry, exit, and sunk costs

79. Mobility conditions (the ease of entry and exit) are critical determinants of market outcomes; concentration is secondary. If costs of entry and exit faced by potential entrants into the local exchange market are low, Ameritech's ability to exert market power is limited. If Ameritech attempted to discriminate in price, quality, or any other dimension of access, it would be foiled by the profit opportunity thereby created for potential entrants or actual competitors. For example, suppose Ameritech attempted to degrade the quality of access provided to competitive long distance providers. The threat of opportunistic entry serves as a deterrent

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79 Merrill Lynch, in analyzing the Sprint/Cable/CAP alliance, concludes that this type of venture "can make a significant return in the residential wired telephone market." ("The Economics of the Sprint/Cable Alliance," Merrill Lynch, February 10, 1995 at p. 5.)

80 "AT&T And Teleport Strike Deal To Bypass Access In 9 Cities," *Washington Telecom Newswire*, Aug. 29, 1996.

against discriminatory behavior. The provisions of the Act, requiring Ameritech to provide unbundled network elements to existing and potential local competitors makes such opportunistic entry very easy – the entrants need only incur minimal sunk costs. With easy entry, any discrimination by Ameritech would create a profit opportunity for a potential competitor, who could enter as a competitive access provider, or enter as a competitive local exchange carrier by leasing the unbundled loop, and providing access to long distance carriers. Of course, actual competitors would also discipline an incumbent; but the threat of entry can be an effective discipline even if the incumbent faces little or no actual competition. This is the sense in which market concentration is secondary to entry conditions.

80. The Harris-Teece Affidavit[81] documents the extent of actual competition in local exchange and access in Michigan, showing that actual competition is vigorous and increasing. This activity indicates the viability of local exchange competition, and how potential entry can serve to curb anti-competitive behavior. Observed competitive entry coupled with significant regulatory developments will pave the way for continued, indeed accelerating, future competition.

81. Entry conditions are critical to market outcomes. One risk faced by a potential entrant is that the profit opportunity may turn out to be short lived, if the incumbent responds to the entry by changing its own behavior; or the opportunity may turn out to be illusory if, for example, the entrant turns out to be a less efficient provider than it had anticipated. These entry risks are smaller the greater the extent to which the rival's entry costs are reversible, and the extent to which there are no other exit-specific costs. In the extreme in which there are no sunk costs, this risk associated with a strategy of opportunistic entry is minimized because the entrant can exit without incurring a cost if the market turns sour.

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81 Harris-Teece Affidavit, *op. cit.*

82. When there are some sunk costs of entry, a full understanding of the market outcome requires a more subtle strategic analysis of the competitive interaction between the entrants and the incumbent. The expected result is not as transparent as it is in the world of perfect mobility and no sunk costs. Threats and aggressive tactics must be evaluated for profitability and credibility. However, policy makers should not take seriously a scenario in which potential entrants forego profitable entry opportunities in local exchange services out of fear of aggressive pricing tactics by the incumbent ex post. The first reason is that Ameritech stands little chance of predating successfully against the likely entrants in the local exchange, as many of these companies are the very same large IXCs examined in Section V above, while the others are well capitalized either through the capital markets (e.g. Brooks) or as offspring of large companies, such as TCG (the cable companies) and MFS (WorldCom).

83. The second reason is that the unbundling and resale of the local exchange mandated by the 1996 Act have significantly improved the ease of entry into local exchange services and decreased entry-deterring sunk costs. The Act requires the unbundling and resale of:

- Local loop transmission from the central office to the customer's premises (§271.c.2.B.iv);
- Local transport from the trunk side of a wireline local exchange carrier's switch (§271.c.2.B.v);
- Local switching (§271.c.2.B.vi);

Furthermore, FCC Order 96-325 clarifies the Act, mandating the additional unbundling of:

- Network interface devices;
- Tandem switching;
- Interoffice transmission facilities;

- Signaling and call-related databases;
- Operations Support Systems functions;
- Operator services; and
- Directory assistance facilities.

84. The ability to purchase these unbundled network elements and services at cost-based prices greatly reduces an entrant's sunk costs when entering the local exchange market. In fact, the unbundling and resale provisions allow entry by a company that purchases all network elements from the incumbent LEC and simply provides its own billing and customer service functions. Loops and switching can now be purchased as unbundled network elements, while transport has been available on an unbundled basis for quite some time. Facilities-based switching generally is not sunk because switches can be redeployed elsewhere. Sunk costs in local exchange services are more likely to be in the loop. By unbundling the loop, entrants can provide their own switches and avoid most of the sunk costs by leasing the loop from the incumbent.[82] Without the need to construct bottleneck facilities, both the total investment costs of entry and the amount that must be irrevocably committed to a particular market can be significantly reduced. Therefore, unbundling has the direct effect of making entry more attractive.

85. There is also evidence that new technologies are reducing the sunk nature of customer access to the local loop – cable TV may elect to provide residential loops; wireless technology may be used to provide the loops, as addressed in the Harris-Teece Affidavit. The reduction in (sunk) investment requirements for entry into local exchange unambiguously decreases the direct entry risk described above. Whether strategic pricing possibilities are a concern depends on whether there are realistic scenarios under which Ameritech could adopt

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82 See estimates presented in the Reply Affidavit of John C. Panzar, in support of Ameritech's Motion to Remove the Decree's Interexchange Restriction, *US v. Western Electric*, No. 82-0192, D.D.C., filed April 1994.

pricing tactics that could induce the entrant to surrender and exit permanently or for an extended period. In our view, the strategic risk is not a significant risk at all because predation by Ameritech is not likely. The idea that Ameritech could or would wage a price war of attrition is foolish on the face of it, as the costs to Ameritech would be exorbitant, and the prospects of victory slim. Further, even if Ameritech had some prospect of winning a war of attrition in the local exchange market, the profitability of such a strategy requires that, at some future time, local exchange prices be raised to supracompetitive levels in order to recoup the costs of the fight. It is rational for a firm to attempt to force exit only if it can afterward achieve and maintain monopoly prices. For Ameritech, such a strategy would be futile. Regulation and the modest entry conditions for local exchange service resellers and regional operators render the maintenance of monopoly pricing in local exchange a most unlikely scenario. Even if Ameritech could force a company that owned local exchange capacity to exit, the physical capacity would remain in place, allowing a new firm to take over and respond as soon as Ameritech raised its prices again. Moreover, current and emerging technological alternatives ensure that competition could not be squelched permanently in this fashion.[83] Consequently, Ameritech has no mechanism for recouping the costs of fighting a price war in the local exchange.

86. The level of regulatory safeguards and the strength and size of the parties is clearly more than adequate to throttle any attempt at unfair pricing tactics by Ameritech. Additionally, Ameritech depends on the IXCs for access revenues as well as for the provision of long distance service to its customers. That leads us to conclude that the decreases in sunk costs only serve to enhance the attractiveness of entry, as unbundling will greatly assist entry, allowing entrants in many instances to "pay as they go" instead of incurring sunk costs.[84]

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83 "The InterLATA Restriction in Light of Changing Technology, Increased Competition, Strengthened Regulation and Ameritech's Customers First Plan," David Teece, submitted to the DOJ, November 1993.

84 Reply Affidavit of John C. Panzar, Ameritech Motion to Remove Interexchange Restrictions, *op. cit.*

E. Ameritech will be one of several major competitors offering integrated telecommunications packages

87. As shown below, all of the major IXCs are already pursuing alternative local access arrangements, including *de novo* entry and joint ventures with existing access providers and likely future providers.

88. For example, AT&T has recently made acquisitions in wireless, Internet, and broadcast services in order to offer integrated packages of these services and bundled discounts.[85] Indeed, AT&T's stated strategy is to "offer customers an innovative package of services, that include home entertainment, as well as local, long distance, wireless and on-line services."[86]

89. MCI has forged alliances with Microsoft, Westinghouse, PointCast, Inc., PageNet, and SkyTel, to offer integrated packages combining services such as long distance calling, cellular, Internet access and services, one number routing, home security, paging service, a personal 800 number, and a calling card, all on the same bill.[87] MCI has also separately allied itself with Microsoft and Digital, to offer its own local- and wide-area network services bundled with Microsoft BackOffice suite and Digital hardware and support.[88] MCImetro, MCI's local subsidiary, is marketing networkMCI Local Service which provides business customers with local telephone service, domestic and international long distance, data communications, paging,

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85 AT&T offers discounts of up to 25% when long distance service is bundled with cellular and paging services, see "AT&T's New Calling Plan," *Newsbytes News Network*, August 21, 1995. Through its WorldNet(SM) Services, AT&T currently offers free Internet access to its long distance customers and provides discounts on Internet services such as Easy World-Wide WebSM to its 800 and 888 customers.

86 AT&T CEO Robert Allen's statements in "AT&T Adds Home Entertainment to Consumer Offer," *PR Newswire,* March 25, 1996.

87 Louise Kehoe, "Microsoft Enters Network Alliance with MCI and DEC," *Financial Times*, April 10, 1996, p. 17.

88 Louise Kehoe, "Microsoft Enters Network Alliance with MCI and DEC," *Financial Times*, April 10, 1996, p. 17. And "MCI Moves for Microsoft Communications," *IAC Industry Express*, June 3, 1996, p. 18.

cellular, and Internet access services.[89] MCI's acquisition of Nationwide Cellular, the nation's largest cellular reseller, in May 1996,[90] has enabled MCI to expand the availability of its cellular packages, which include local, long distance, and other integrated services.[91] And through agreements with Nextwave Telecom, the largest bidder in the PCS C-Block auctions, MCI will purchase up to 10 billion minutes of PCS airtime and market it under its own brand name along with its other service offerings.[92]

90. Sprint has formed the Sprint Telecommunications Venture with TCI, Comcast, and Cox Communications, Inc., to "create an unprecedented communications alternative, packaging local telephone, long distance, and personal communications with cable services into a single offering for consumers and businesses... Consumers can look forward to the widest possible array of communications and entertainment services delivered with unsurpassed quality and with all the assurances and conveniences of a strong national brand."[93] As of May 1, 1996, Sprint's local telephone operations adopted the Sprint name, because of its belief that "in a competitive communications environment, it's important that [Sprint's] customers know their local telephone service provider is part of the same company that can connect them with the world."[94] Sprint is the ninth largest local exchange carrier in the U.S. and maintains extensive technology and

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89 "MCI Debuts Local Offering in Cleveland Metro Area," *IAC Industry Express*, July 29, 1996, vol. 14, no. 16. The service is offered in New York, Boston, Chicago, Detroit, Philadelphia, Pittsburgh, Seattle, Baltimore, Hartford, Milwaukee, and Cleveland (which is still awaiting tariff approval).

90 "MCI Communications Corp.," company developments summary, downloaded from the Washington Post's "Post 200—Top 100 Public Companies" Web site. Http://www.washingtonpost.com, 12/23/96.

91 "MCI Expands Breadth of Cellular Coverage," *IAC Industry Express*, July 29, 1996, vol. 14, no. 16; "MCI Adds Local Cellular Services in Atlanta, Detroit and Greater Michigan," *Business Wire*, June 26, 1996. Additional markets include New York, Chicago, Los Angeles, Boston, San Francisco, Washington/Baltimore, Philadelphia, San Diego, Milwaukee and southern Florida.

92 Lawrence M. Fisher, "MCI Joins Nextwave in Wireless Communications Venture," *New York Times*, August 27, 1996, p. C4.

93 Notice of Ex Parte Communications By Sprint in R.95-04-043/I.95-04-044, June 5, 1995.

industry knowledge, as well as expertise it could use to evaluate possible discriminatory behavior.

91. Meanwhile, the fourth largest IXC, WorldCom, announced its merger with MFS on August 26, 1996. MFS CEO James Crowe stated that "the merger will allow MFS to redeploy about $400 million in capital expenses from inter-city fiber to local networks, and the two companies will undertake a "major expansion" to boost the current 30 percent overlap between MFS and WorldCom central offices" and that "the combined long distance, local and Internet carrier will have a distinct advantage over rivals in offering bundled services." And WorldCom CEO Bernard Ebbers stated: "[the] key to the merger is that selling bundled services reduces churn by about half, which will have a 'dramatic impact on growth.'"[95] MFS had previously merged with UUNet, to allowing it to include Internet access and services in its integrated package offerings.[96]

92. The major IXCs are moving toward integrated service provision because they believe that the ability to offer consolidated packages of telecommunications services, including interLATA service, is a formidable source of competitive advantage for these firms over incumbent LECs, especially as the RBOCs are currently restricted from offering in-region long distance service, a critical component of any integrated telecommunications package. Consequently, this push towards integrated service provision will only increase the scope for alternative local access arrangements, and thus make it much more risky for Ameritech to engage

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94 Comments by Darrell Kelley, president of Sprint's local Florida operations, in "Sprint Launches Familiar Weapon in Telecom Brand Battle; Unveils New Image Campaign for Local Division: 'Here's Where It Gets Easier,'" *Business Wire,* May 2, 1996.

95 "Internet Growth And Regulatory Change Drive WorldCom-MFS Merger," *Washington Telecom Newswire,* August 26, 1996.

96 "The merger will create one of the world's premier business communications companies, providing a single source for a full range of Internet, voice, data and video services – over its advanced international fiber network." See "MFS and UUNet Announce Merger Agreement to Form Premier Internet Business Communications Company," *PR Newswire,* April 30, 1996.

in access discrimination. Consumers will benefit from the integration of service offerings and the marketing of bundled products through convenience and through the increased number and variety of telecommunications options available in the marketplace.

IX. CONCLUSIONS

A. Discrimination is not a reality

93. Our analysis has shown that quality discrimination is not likely to occur because the regulatory, technical and economic safeguards already in place will prevent such behavior on the part of Ameritech. Experience in markets in which Ameritech and other LECs provide interconnection services to a direct competitor provides evidence that these regulatory safeguards are effective. IXCs and other CLECs are building extensive marketing and infrastructure capabilities to participate in all sectors of the telecommunications market. They would not be taking these actions and making these investments if they did not believe they could undertake viable entry, and be protected from anti-competitive behavior. Where competition has been permitted, Ameritech and other LECs have not engaged in any quality discrimination against their rivals even though such discrimination may have been possible. Thus, we conclude that such discrimination, as alleged by the IXCs, is not likely to occur if Ameritech is granted interLATA relief.

B. Ameritech's entry into long distance is likely to be pro-competitive

94. There should be a presumption in favor of *de novo* entry, even if it is in a downstream market in which a firm is both a supplier to and a competitor of its customers. In this affidavit we have shown that any possible anti-competitive effects are checked by the state of the market as well as the many regulations imposed upon Ameritech. Competition from CAPs and entrants in local service diminishes Ameritech's incentives to discriminate on quality, while the state and federal price cap regulations virtually eliminate any incentive for cost-shifting.

Competition is assisted by the unbundling and resale requirements of the Act, which greatly facilitate entry and lower the level of sunk costs associated with it. Finally, even if Ameritech were to engage in anti-competitive discrimination, for whatever reason, this behavior would be easily detected by its IXC competitors and punished by the regulators. Both Ameritech and its competitors are keenly aware that this Commission retains the power to withdraw any interLATA authority that it may award. We therefore conclude that Ameritech's entry into long distance service is unlikely to have anti-competitive effects, and it is likely to be pro-competitive.