

consumers may be more fearful of risking a change in their local service provider. After all, if their long distance service failed for some reason, consumers still could communicate locally and could always use an access code to reach another long distance provider. If the local service provider fails, there is no dial tone period. The consumer cannot make any calls, local or long distance. New entrants to the local market are not likely to be given many second or third chances by subscribers. Unfortunately, because of the dependence on the BOC for network elements and wholesale services, a substantial portion of a new entrant's service quality rests with the BOC against which the new entrant is competing. This has significant and pertinent ramifications for competition in both the local and the full service market.

Moreover, unless and until the problem of excessively priced exchange access is resolved, long distance and full service competitors will be bearing substantially higher exchange access costs than the BOC.³⁴ The cost borne by the BOC's competitors is the access rate; however, when the BOC itself is the interexchange carrier, the effect rate its to itself is economic cost. Thus, until this access disparity is remedied (and universal service funds are collected and distributed on a competitively neutral basis), the BOC's competitors will be involuntarily financing a massive war chest that the BOC alone can unfairly use to subsidize its competitive services. In markets where profit margins are calculated on the basis of fractions

³⁴ Stand alone long distance carriers and full service providers using the BOC's wholesale services to provide local service will pay excessive access costs on both the originating and terminating ends of a call. Full service providers using their own local facilities or network elements leased from the BOC at forward looking economic cost, will pay inflated access rates only on the terminating side. On the originating side, assuming the local competition provisions of the 1996 Act and the FCC's regulations thereunder are fully implemented, these full service providers should face roughly the same cost structure as the BOC.

of cents per minute, excessive access rates will greatly contribute to the BOC's ability to impede competition.

The BOCs' incentive to discriminate against their competitors will be heightened after they gain authority under section 271 to provide long distance service. Because the BOCs must satisfy the "competitive checklist" in section 271 and comply with the FCC's rules and regulations implementing section 251 in order to be granted authority, the BOCs have reason to make a good show of cooperating in opening up their monopoly markets to competition.³⁵ Once the ultimate prize of section 271 authority is granted, however, there is little to constrain the BOCs' incentive and ability to impede competition in the local, long distance and full service markets.

The threat posed by the prospective entry of the BOCs into the long distance (and, thus, the full service) market is sufficient to spur long distance companies to enter the local market. In fact, all of the large and most of the smaller long distance carriers are already in the process of doing so. As a direct result of the 1996 Act, not only is WorldCom preparing to enter the local market, but WorldCom also is in the process of merging with MFS, Inc., the largest of the competitive local exchange carriers.³⁶ Other long distance carriers have been devoting enormous resources to negotiations and arbitrations pursuant to sections 251 and 252 of the 1996 Act, while still others have entered into strategic local telephony partnerships with cable

³⁵ Nevertheless, even now the BOCs are strenuously resisting competition in their markets. They are waging battles in the courts and before state commissions to prevent or stall the implementation of 1 + dialing parity, operational support systems, and forward looking economic costs. They are also attempting to limit the means by which competitors are able to enter the local market by attempting to restrict the use of unbundled network elements.

³⁶ WorldCom anticipates that the transaction will close prior to the end of 1996.

MSOs³⁷ or wireless carriers.³⁸ With the clamor for long distance companies to enter the local market already rising to a fever pitch, actual entry by the BOCs could not increase the incentive any further.

5. To what extent will the costs and benefits of entry, as felt in any market, vary under an entry standard that supports early entry, versus a standard that is likely to delay entry? Will there be a first mover advantage associated with the ability to offer integrated services, and if so, how significant is that advantage?

Entry by the BOCs into the long distance market before conditions in the local market are sufficient to sustain competition there will place competition in all markets in substantial jeopardy. As discussed above, because of the broad competition in the long distance market, the BOCs face a much simpler task in entering the long distance market and adding long distance service to their product mix than do potential competitors seeking to enter the local market and add local service. Therefore, as also discussed above, premature entry by the BOC will increase its incentives to use its local market power to discriminate against its competitors in all markets. It is unlikely that early BOC entry will substantially increase long distance competition because the long distance market is already competitive; the only pressure the BOC will be able to put on long distance rates will be through anti-competitive abuse of its local market power -- which ultimately will destroy the existing competition. Early entry brings with it great risk but little benefit.

³⁷ Sprint, for example, was involved in a joint venture that included Cox Communications, Time Warner, and TCI.

³⁸ For example, AT&T now owns McCaw Cellular and MCI has entered into an agreement to purchase an enormous amount of wireless capacity from NextWave.

Delaying BOC entry will allow competition to develop in some markets. It will permit the time necessary for full implementation of the requirements of section 251 of the 1996 Act and the FCC's interconnection order, and for systems to be established that will enable equitable competitive opportunities in all parts of the marketplace. When conditions are appropriate, the BOC will have less ability to use its local market power to impede competition in any market. Unlike early entry, later entry brings little risk but potentially great benefit.

There is a substantial first mover advantage that flows to the BOCs if they are permitted to offer integrated services before local market conditions allow other carriers to offer integrated services as well. The best examples of this first mover advantage are the experiences with GTE and SNET noted above; they are able to achieve their market share and growth rate because no one else in their territories has the capability to offer integrated services. Customers that want one stop shopping have no opportunity to choose another carrier, and they can switch to GTE or SNET by changing their long distance carrier, not their local service -- which customers are long accustomed to doing.

Long distance carriers seeking to enter the local market in order to be able to offer integrated services have no such first mover advantage. Instead, they are more like pioneers bushwacking into a new frontier. The 1996 Act and the FCC's rules have not been fully implemented, and support systems are currently not in place to support local entry. Moreover, carriers entering the local market must persuade customers to change their local service provider, something with which customers have no experience, and may have some trepidation. It is unlikely that new entrants to the local marketplace will have any first mover advantage in

the provision of integrated services even if they start before the BOCs enter the long distance market.

Conclusion

The analytical framework used by the Department to evaluate BOC section 271 applications must reflect the realities that BOC entry will affect competition in the full service market and that, once a BOC is granted entry, its pre-approval incentive to cooperate with the development of competition will be reversed. The Department must also recognize that it will be much easier for the BOCs to enter the long distance market than it will be for potential competitors to enter the local market. WorldCom believes that the risks of early entry by the BOCs outweighs any short-term benefit they might bring.

Respectfully submitted,



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Opposition of WorldCom, Inc.
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7870

December 13, 1996

VIA COURIER

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Re: MFS Position Paper on Bell Operating Company Entry into Interexchange Markets

Dear Mr. Russell:

Enclosed is the original and 10 copies of MFS's position paper on Entry of Bell Operating Companies into In-Region InterLATA Markets.

Please call me at (202) 424-7872 if you have any questions or if we can provide any additional information that would be useful to the Task Force.

Sincerely,



Mark Sievers

cc: David Porter

DEPARTMENT OF JUSTICE
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**Position Paper of
MFS Communications Company, Inc.
on Entry of Bell Operating Companies
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Dated: December 13, 1996

**DEPARTMENT OF JUSTICE
ANTITRUST DIVISION**

**Position Paper of
MFS Communications Company, Inc.
on Entry of Bell Operating Companies
into In-Region InterLATA Markets**

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**Position Paper of
MFS Communications Company, Inc.**

INTRODUCTION AND SUMMARY

MFS Communications Company, Inc. ("MFS"), by its undersigned counsel, hereby submits this paper in response to the Antitrust Division's solicitation of November 21, 1996.

As it analyzes the consequences of Bell Operating Companies ("BOCs") entering the interLATA markets of their home regions,^{1/} the Department of Justice ("Department") should carefully consider the potential anticompetitive risks of such entry in both the long distance and local exchange markets throughout the country. Because they are the largest incumbent local exchange carriers in most markets, the BOCs control both the access expenses of their long distance competitors and access to the essential network elements that potential local exchange competitors need to provide viable, competitive alternatives to the BOCs. The BOCs can leverage their control over long distance access services to destroy competition in the long distance market and have economic incentives to restrict the development of local telephone competition in order to retain their ability to leverage control over access services. The Department should focus on the risk of harm to competition in these markets since -- given the robust competition that already exists in the long distance market -- the potential competitive and consumer benefits of BOC entry are arguably *de minimis* relative to the risk of irreversible competitive harm.^{2/}

^{1/} This paper will refer to the scenario of BOCs entering in-region interLATA markets as "BOC entry."

^{2/} The long distance market is marked by spirited competition between providers offering both resold and facilities-based service. Prices in the long distance market declined substantially since divestiture (and especially with the advent of equal access), and long distance consumers can choose between a variety of carriers, new services and
(continued...)

On the other hand, the potential for anticompetitive harm from BOC entry is substantial and could easily reverse the competitive benefits in today's long distance market. Broadly speaking, the BOC's anticompetitive potential to leverage access charges can be addressed in three ways:

- ▶ ***Reduce and maintain access charges (both long distance access and access to essential local network elements) at economic costs.*** This would reduce the ability of BOCs to leverage access charges to obtain a competitive advantage over long distance and local exchange rivals, but it is unclear when and to what extent access charges will be restructured. Likewise, while the Telecommunications Act requires cost-based charges for interconnection and unbundled elements, BOC prices for access to unbundled elements are far from the cost-based levels and the FCC's efforts to set the price of essential local network elements at economic cost has been stayed,^{3/} so it is unclear how effective regulators will ultimately be in this area. Also dramatic reductions in long distance access charges will reduce incentives for competitors to enter access markets and provide competitive alternatives to the BOCs' access services, so it is unclear whether, in the long run, this policy option advances or retards competition.

^{2/} (...continued)
promotions. In addition, there are four major national facilities-based long distance carriers and scores of regional carriers. It is not clear what, if any, incremental consumer benefits would be realized by BOC entry into interLATA long distance markets. Clearly, however, the long distance industry is substantially more competitive than local exchange markets.

^{3/} *Iowa Utilities Board, et al. v. Federal Communications Commission and United States of America*, No. 96-3321 (8th Cir.)

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- ▶ ***Promote the development of effective local exchange competition.*** The BOCs' ability to leverage access charges to gain a competitive advantage is blunted when there are competitive alternatives to their essential local exchange facilities. The development of any available alternatives to the BOCs' local exchange networks, however, has barely begun. Since it took more than a decade for MCI, Sprint, Worldcom, and others build facilities and offer services to reduce AT&T's market share to 70%, it seems unreasonable to expect robust local exchange competition to universally emerge over the next several years.
- ▶ ***Spin-off the BOCs' local loop/access facilities from its other activities.*** The most effective means of preventing anticompetitive abuse by the BOCs is to spin-off their essential (local loop and access) facilities from other activities. In that instance, the spun-off access/loop company would have no economic incentive to favor a BOC long distance offering or disadvantage BOC long distance or local exchange competitors.

MFS believes that the BOCs can quickly enter the interexchange market without adversely impact competition by spinning off their local loop activities and facilities into a company separate from their other, competitive activities. Such an action, as described below, eliminates the ability and incentive of BOCs to leverage their control over essential facilities to retard competition in long distance and local exchange markets.

At a minimum, BOC entry into interLATA markets should not occur until and unless markets evolve such that the BOCs cannot leverage their control over essential facilities. Such control will not be eliminated until a host of technical implementation issues have been addressed and resolved.

I. BOC ENTRY CAN BE QUICKLY ACCOMMODATED WITH MINIMAL COMPETITIVE HARM BY SPINNING OFF THE BOC LOOP FACILITIES

If BOCs are anxious to enter in-region long distance markets and are not interested in waiting for effective facility-based competition to develop, they can quickly satisfy the stringent requirements of Section 271 by bifurcating their businesses. MFS urges the BOCs that wish to quickly enter the long distance business to consider establishing two entities:

- ▶ **Local Loop Entity.** This would consist of all of a BOC's local outside plant facilities (*i.e.*, the local loop), including the main distribution frame and intermediate distribution frames, central office buildings and power plants, associated operations support resources and intraexchange, non-switched marketing in one entity.
- ▶ **Retail/Switching Entity.** This would consist of a BOC's remaining switching, interoffice transmission, related support organizations and switched service marketing activities and assets.

Both entities would still have to satisfy the checklist requirements of Section 271 to enter and compete in interLATA markets, but, in MFS's opinion, it would be far easier for the Retail/Switching entity to satisfy the tests when it does not provide essential services (*i.e.*, local loops or access services) to competitors.

Switching functions are more likely to be competitively provided than loop facilities for several reasons:

- ▶ **Scale Economies in Switching.** With the deployment of digital electronics and fiber optic transmission facilities, one would expect economies of scale in switching and interoffice transmission. As a result, the incremental costs of such functionalities are

likely below the average embedded costs of deploying switching and interoffice transmission facilities, making it more economical for a new entrant to build such facilities (and face the incremental costs of deployment and construction) rather than buy them at a price approximating average costs.

- ▶ ***Customer Control and Product Differentiation.*** The switch forms the heart of any carrier's network and defines the nature of contacts a carrier will have with customers as well as the products a carrier might offer to distinguish itself from its competitors. Many, if not all, competitors will likely find it in their economic self interest to deploy their own switches at the earliest possible moment to exercise control over their networks, their proprietary customer information, and to add features or implement pricing options that differentiates them from their competitors.^{4/} In contrast, "a loop is a loop" and deployment of loops by competitors does not confer any product differentiation capabilities.
- ▶ ***No Scale Economies in Loop Provisioning.*** For loops less than 18,000 feet long, twisted copper wire pairs remains the preferred technology for provisioning local loops. The technologies of deploying local loops have not changed materially in 50 years (telephone poles, buried cable, conduit), while material and labor costs have escalated. In addition, other placement costs -- securing rights-of-way, ensuring

^{4/} This incentive is illustrated by the widespread deployment of private branch exchanges (PBXs) in the general business market and the development of the shared tenant services segment of the telephone industry. Both are focused on the deployment of switching and localized transmission. In contrast, there has far less interest in deploying widespread networks or transmission capabilities that reach individual customers.

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compliance with environmental and esthetic concerns, dealing with congestion -- have increased so one would expect that the embedded cost of loop facilities may well be below the incremental costs of deploying new loops.^{5/} Thus, entry into the loop segment of the market could be forestalled simply by pricing above the embedded costs of loop plant but below the costs of installing new facilities.

Spinning off a BOC's loop and switching functions creates two separate companies -- one that provides the essential loop facilities that cannot be easily duplicated by competitors and one that provides competitive services. The Retail/Switching entity would buy loops and other essential facilities from the Local Loop entity just like any other competitor. Because it does not control the local loops, the Retail/Switching entity would not have the ability to harm competition by leveraging control over essential facilities. Because it does not provide competitive services (because it does not have a switch), the local loop entity would not have an incentive to leverage its control over essential facilities to gain an unfair competitive advantage in a vertical market.

In order to facilitate quick compliance with the requirements of Section 271, these proposed new entities must not be affiliates. If they remain affiliates, neither could qualify to enter the interLATA market until both had satisfied the checklist requirements of Section 271.^{6/}

^{5/} The possibility that the costs of deploying new facilities may be higher than embedded costs was raised in a recent letter to the FCC signed by five of the Department's former chief economists (Bruce Owen, Lawrence White, Frederick Warren-Boulton, Robert Willig, Janusz Ordover) (Dec. 3, 1996).

^{6/} If they were affiliates, each entity must be treated as a "Bell Operating Company" because they would be a "successor or assign" that provides wireline telephone exchange services. 47 U.S.C. §3(4)(B). Both entities are providing "wireline

(continued...)

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However, if they are separate companies, the Retail/Switching entity could satisfy the Section 271 checklist requirements independent of the Local Loop entity. Since it no longer provides local loops, the Retail/Switching entity would easily and quickly satisfy many of the Section 271 requirements.

In addition to satisfying BOC demands for a way to quickly enter the interexchange and equipment manufacturing segments of the telecommunications industry, splitting BOCs into Local Loop and Retail/Switching entities satisfies a number of other competitive and policy concerns:

- ▶ **Subsidy Debates.** Breaking up the BOCs ends debates about pricing vertical services to provide an appropriate subsidy for local loops. The Local Loop entity will simply charge a price sufficient to cover its costs, and regulators and firms will no longer have to agonize over how much contribution from vertical services is appropriate. Instead, regulators would directly set the price of local loops based on a straight-forward determination of the costs of the loop. The debates about access reform and universal service would be dramatically simplified.

^{6/} (...continued)
telephone exchange service." The Retail/Switching entity is clearly providing wireline telephone exchange service to the public for a fee. Similarly, the Local Loop entity would provide wireline telephone exchange service for a fee. Since it would sell loops primarily to telecommunications carriers, the only issue might be whether it will offer its services "to the public or such classes of users as to be effectively available to the public." However, so long as the Local Loop entity is not prohibited from selling loops to the public it will satisfy the "to the public" portion of the test. There may be many instances where individuals or non-telecommunications carriers (e.g., Internet providers, banks, schools, alarm monitoring companies seeking to configure dedicated, high-speed connections with customers) might wish to purchase and use the loops provided by the Local Loop entity.

- ▶ **Collocation Debates.** Including local central office building space and power plant in the Local Loop entity eliminates debates about collocation that have stymied interconnection between competitive entrants and incumbents. As the Department is aware, some BOCs have been demanding as much as \$250,000 to provide 100 square feet of caged space in their central offices, and the extent to which incumbents must allow collocation and interconnection by competitors is a contentious issue. Since the Local Loop entity must interconnect with others to sell its loops, that creates a powerful economic incentive favoring collocation and interconnection.
- ▶ **Provisioning Debates.** A Local Loop entity that is in the business of selling loops will be economically incented to provide the loop assignments, improvements, repair, maintenance and electronic operating support system interfaces that its customers want. In contrast, vertically integrated BOCs tend to view interconnectors as competitors and have economic incentives to delay the provisioning of advanced loop features or demand excessive prices for loops used by the competitors.

It is important to emphasize that the BOCs could spin off their Local Loop functions today to facilitate easy entry into interLATA markets. Certainly, some telecommunications companies are pursuing vertical and horizontal integration as a competitive strategy. However, as AT&T (spin off of Lucent Technologies and NCR), Pacific Telesis (spin off of Air Touch), and Sprint demonstrated (spin off of 360 Degree Communications), spin-offs of operations that are inconsistent with a company's primary competitive interests in this industry are feasible and quickly accomplished. If any BOC's management believes that its entry into

long distance and telecommunications equipment manufacturing will significantly increase its shareholder value, they have options under their control to quickly achieve that goal.

As described below, the threats to competition are substantial if the BOCs are allowed to enter long distance markets on a vertically integrated basis. The Department should not turn its back on competition and the American public by yielding to what will likely become unremitting political pressure to allow premature BOC entry.

II. BOC ENTRY ON A VERTICALLY INTEGRATED BASIS THREATENS COMPETITION IN BOTH THE LONG DISTANCE AND LOCAL EXCHANGE MARKETS

BOC entry into interLATA markets on a vertically integrated basis endangers competition in the long distance market and the prospects for competition in local exchange markets. BOCs' control over essential access services threatens competition in long distance markets. Absent vigorous intervention and enforcement by regulatory agencies, including the Department, the BOCs' control over essential network elements -- especially the local loop -- diminishes the possibility that vigorous local exchange competition will emerge to lessen the BOC stranglehold on access. Because of their position, the BOCs can engage in a variety of price and non-price actions with anticompetitive consequences in both the local exchange and long distance market. Indeed, if BOCs compete in interLATA markets, they have an economic incentive to forestall competition in the local exchange market as such competition diminishes the BOCs' ability to leverage control over essential access services.

A. BOC Entry Threatens Competition in the Long Distance Market

BOCs enjoy an overwhelming competitive advantage over long distance carriers because BOCs supply access services, a long distance carrier's largest expense. It is widely recognized that long distance access charges are set substantially above the cost-based level one would expect to persist in a competitive market.²⁷ If BOC entry is allowed, BOCs will be able to drive long distance competitors out of the market by leveraging the subsidies embedded in access charges. The economic dynamics of the problem are illustrated by the tables that follow.²⁸ Table 1 is the Base Case. It illustrates a market where long distance firms sell services for 22¢ a minute. Their incremental costs for the services, a total of 13¢ a minute, consist of the access charges paid to the BOCs, assumed to be 7¢ a minute, and other costs assumed to be 6¢ per minute. Their common costs are assumed to be \$300 million or about 33% of total costs. The volumes of 10 billion minutes are simply assumed for the illustration.

²⁷ A survey of subsidy mechanisms in the telecommunications industry was prepared by the FCC Staff in Common Carrier Bureau, *Preparing for Addressing Universal Service Issues: A Review of Current Interstate Support Mechanisms*, pg. 26 (Feb. 23, 1996). A review of telecommunications subsidy studies is in C. Weinhaus, *et al.*, *Apples and Oranges: Differences between Various Subsidy Studies*, Telecommunications Industry Analysis Project (July 19, 1995).

²⁸ The numerical example is drawn from MFS Comments filed in In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended; and, Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area, CC Docket No. 96-149 (Aug. 15, 1996), Attachment 1.

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Table 1 -- Base Case

BELL OPERATING COMPANY -- BASE CASE						
Service	Price	Unit	Volume (minutes)	Total		Margin (Profits)
		Costs		Revenues	Costs	
Long Distance	22¢	10¢ (3¢ access + 7¢ other)	2 billion	\$440 million	\$200 million	\$240 million
Access	7¢	3¢	10 billion	\$700 million	\$300 million	\$400 million
Common or Fixed Costs					\$400 million (44% of total costs) (approximately 3.3¢/minute)	(\$400 million)
Total				\$1.14 billion	\$900 million	\$240 million
COMPETITOR -- BASE CASE						
Long Distance	22¢	13¢ (7¢ access + 6¢ other)	10 billion	\$2.2 billion	\$1.3 billion	\$900 million
Common or Fixed Costs					\$300 million (33% of total costs) (approximately 3¢/minute)	(\$300 million)
Total				\$2.2 billion	\$1.6 billion	\$600 million

The BOC in this simple example sells two products -- access for 7¢ a minute and long distance services for 22¢ a minute. In this example, the economic costs of access are assumed to be 3¢ a minute and the access volumes realized by the BOC are, of course, the 10 billion minutes of long distance volumes generated by its long distance competitor. The figures in Table 1 assumes that the BOC also sells long distance services for 22¢ a minute. Unlike its long distance competitor, because the BOC supplies its own access services, the BOC's long distance access costs are not the price of access (7¢), but rather the economic

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cost of access, namely, 3¢ a minute. The figures in Table 1 arbitrarily assume that the BOC is less efficient than its long distance rival in that the BOC's non-access incremental costs are 7¢ a minute (1¢ higher than its rival) and its common costs are 44% of total costs (33% (11 percentage points) higher than its long distance rival). Thus, the BOC's total incremental long distance costs are 10¢ a minute (7¢ of non-access costs plus 3¢ of access costs).

What are the competitive implications if the BOC is allowed to compete in the long distance market using their in-region networks?^{9/} Table 2 demonstrates what happens to the profits of both companies if the BOC lowers its long distance rates, for in-region customers, closer to its costs. In Table 2, the BOC reduces long distance rates, for calls originated and terminated in-region,^{10/} to its cost of providing the service plus the imputed price of access (7¢ in "other" costs and 7¢ for access). Because the long distance market is competitive, the BOC's rival is forced to follow the price reductions, and is forced out of the market.

^{9/} BOCs would bring extensive network facilities, enabling them to offer long distance services throughout their home regions, to the long distance market. Ordinarily, regulators welcome additional facilities-based carriers to any market. In this case, the Department must be wary of the competitive advantage that BOCs have gained from building vast in-region, interexchange-capable networks under rate of return regulatory environments. Since these networks are currently included in the rate bases of BOCs, they were, and continue to be, funded by captive ratepayers. In contrast, competitors built their facilities without the protection of rate-base regulation.

^{10/} Long distance traffic originates and terminates in-region for BOCs is significant. According to Sprint research in-region long distance traffic amounts to the following: 46% for Pacific Telesis; 43% for US West; 44% for Southwestern Bell; 46% for BellSouth; 47% for Ameritech; 40% for Bell Atlantic; and 36% for NYNEX. Sievers, *Should the InterLATA Restriction be Lifted? Analysis of the Significant Issues*, Presented at Rutgers University Advanced Workshop in Regulation and Public Utility Economics 7th Annual Western Conference (July 6-8, 1994).

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Table 2 -- Strategic Repricing by Vertically Integrated BOC

BELL OPERATING COMPANY						
LOWERS COMPETITIVE PRICE TO COSTS PLUS IMPUTED PRICE OF ESSENTIAL SERVICE						
Service	Price	Unit	Volume (minutes)	Total		Margin (Profits)
		Costs		Revenues	Costs	
Long Distance	14¢	10¢ (3¢ essential + 7¢ other)	2.7 billion	\$378 million	\$270 million	\$108 million
Access	7¢	3¢	13.6 billion	\$952 million	\$408 million	\$544 million
Common or Fixed Costs					\$400 million (37% of total costs) (approximately 2.45¢/minute)	(\$400 million)
Total				\$1.33 billion	\$1.078 billion	\$252 million
COMPETITOR						
FORCED TO FOLLOW BOC'S COMPETITIVE PRICE REDUCTION						
Long Distance	14¢	13¢ (7¢ essential + 6¢ other)	13.6 billion	\$1.904 billion	\$1.768 billion	\$136 million
Common or Fixed Costs					\$300 million (14% of total costs) (approximately 2.2¢/minute)	(\$300 million)
Total				\$1.904 billion	\$1.768 billion	(\$164 million)

The long distance rival is forced out of the market in spite of being more efficient (*i.e.*, having lower incremental and unit costs) than the BOC, and in spite of the fact that the BOC never resorted to below-cost pricing, never was forced to endure a reduction in revenues or profits, and did not raise its access charges. In fact, the BOC experienced an increase in profits!

The BOC's increase in profits occur because, with the lower long distance rates, the volume of the market expands and because of the subsidies embedded in access charges, the BOC earns additional profits on the stimulated long distance volumes. Said differently, the

incremental profits in access charges more than offset any reduction in long distance profits associated with the price reduction.

There are three major actions that could prevent the anticompetitive results illustrated in Tables 1 and 2:

- ▶ **Reduce Access Charges to Costs.** If access charges were not set above costs, the anticompetitive potential of Tables 1 and 2 could not occur because the BOC would not earn supranormal access profits on its competitors stimulated long distance traffic. However, while the FCC has indicated its intention to reform access charges, it has not yet opened the docket, and it is unclear what those reforms will be or whether they will also be applied by state regulators. In addition, it is not clear how this policy would affect competition in the long run since dramatic reductions in access charges would disincent entry into local markets by competitive access providers.
- ▶ **Introduce Effective Competition in Local Exchange Markets.** If long distance competitors had a choice among access providers, they would not be forced to route long distance traffic over the BOC's access facilities thereby benefiting their BOC competitor while matching the BOC's price reduction. Effective access competition would also stimulate natural price reductions in access charges as competitors competed away the supra-competitive profits embedded in the BOC access prices.
- ▶ **Spin off the BOC's Long Distance and Local Exchange Businesses.** If the BOC was not vertically integrated to include both access and long distance, it would not benefit from pricing actions that effectively forced its competitors to stimulate its access profits. The details of separation of the BOC's local loop and competitive

switched activities (including long distance and competitive local exchange offerings) are described in the previous section.

B. The BOCs Entry into Long Distance Creates Economic Incentives to Foreclose Competition in Local Exchange Markets

A BOC that expects to enter and compete in the long distance market has an obvious economic incentive to forestall the development of local exchange competition. The presence of access competitors reduces the ability of the BOC to leverage its control over access charges to disadvantage long distance competitors. Thus, one would expect that BOCs would take steps to foreclose others from providing competitive access services.

In some respects, competitive local exchange providers are in a position similar to long distance carriers in that they must rely on the BOCs for certain essential access facilities. Unbundled loops, for example, are an essential network element that competitive local exchange carriers cannot ubiquitously duplicate in the near future, but which they must use to provide access between long distance carriers and end-user customers. The economic dynamic illustrated in Tables 1 and 2 could as easily describe the competitive relationship between BOCs and competitive local exchange carriers that seek to buy local loops rather than long distance access services.

Attachment 1 presents the unbundled loop prices that Southwestern Bell offered in a Missouri interconnection arbitration with MFS^{11/} and illustrates the incentives of incumbent

^{11/} In the Matter of MFS Communications Company, Inc. Petition for Arbitration Pursuant to 47 U.S.C. § 252(b) of Interconnection Rates, Terms and Conditions with Southwestern Bell Telephone Company, Case No. TO-97-23.

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BOCs to charge competitors exorbitant rates for essential services. Even though it offered a \$14.30 rate for unbundled loops to MFS in negotiations and even though it agreed to a \$14.30 rate in an agreement it signed with Dial US in Missouri, Southwestern Bell argued that its cost-based unbundled loop rate for voice-grade loops using the FCC's pricing methodology was between \$17.15 and \$50.05 per month, plus an additional \$2.15 per month for cross connections that allow a new entrant to connect the unbundled loop to its facility. In addition to these monthly charges for an unbundled loop (*i.e.*, loops without the functionality of local service), Southwestern Bell proposed to charge new entrants non-recurring charges of \$53 to \$99 per loop. Fortunately, the Missouri Commission generally rejected Southwestern Bell's loop rates, but it is not clear how a new entrant could offer a competitively priced local telephone service if forced to pay the allegedly cost-based loop prices proposed by Southwestern Bell.

As another illustration, Southwestern Bell has used its control over central office facilities to extract exorbitant collocation charges from new entrants.^{12/} It is not unusual for Southwestern Bell to demand collocation charges that exceed \$200,000 for the first firm that collocates in a central office and occupies 100 square feet. In contrast, other incumbent carriers charge collocation charges less than \$25,000. Southwestern Bell takes the position that the first firm to collocate in a central office must pay all of the costs associated with upgrading and modifying a central office for collocation, an approach that obviously diminishes

^{12/} Collocation refers to the charges for accommodations an incumbent carrier makes to allow competitors to place and operate equipment in the incumbent carrier's central office. Typically, a new entrant seeks to collocate in order to interconnection its facilities with the facilities of the incumbent carrier, such as local loops. Collocation is an essential element for the use of and access to unbundled loops.

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the attractiveness of collocation. Thus, under Southwestern Bell's proposal, if MFS wished to buy unbundled loops in Missouri to provide competitive access services, it would have to pay the \$200,000+ collocation charges required by Southwestern Bell, plus the \$53 to \$99 per loop non-recurring charges, plus the \$2.15 per month per loop for connecting the loop to MFS's collocated facilities, plus \$17.15 to \$50.05 per month per loop depending on the location of the loop and the grade of service. The level of those charges seem designed to foreclose competitors from using Southwestern Bell's essential facilities.

As another example, early this year US West moved to "grandfather" CENTREX service in the fourteen states of its service territory. By the terms of US West's petition, CENTREX would continue to be made available to existing customers, but no new orders for the service would be processed and stifling limits would be placed on the ability of existing customers to acquire additional lines. Competitors of US West who would otherwise purchase CENTREX service on a wholesale basis for resale to retail customers are foreclosed from entering this market segment by US West's actions. Competitors have been successful at cultivating demand for CENTREX and using the service as a stepping stone to entering particular local exchange markets. US West, on the other hand, offers CENTREX primarily as a convenience for a limited set of retail customers. By grandfathering the service, US West sought to derail emerging competitors without denying itself the ability to continue to