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August 4, 1997

**ORIGINAL**

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Mr. William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, NW, Room 222  
Washington, DC 20554

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AUG - 4 1997

FEDERAL COMMUNICATIONS COMMISSION

Re: International Settlement Rates; Ex Parte  
File No. IB96-261

Dear Mr. Caton:

The attached memorandum supplements the Affidavit of William H. Lehr, which was filed by AT&T in this proceeding on July 10, 1997 as Attachment 3 to AT&T's Comments in Rules and Policies on Foreign Participation in the U.S. Telecommunications Market, File No. IB 97-142, which AT&T also filed in this proceeding.

Two copies of this Notice are being submitted to the Secretary of the Federal Communications Commission in accordance with Section 1.1206(a)(1) of the Commission's rules.

Respectfully submitted,

Attachment

cc: Mark Uretsky  
Doug Galbi  
Kathy O'Brien  
Diane Cornell

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TO: FCC International Bureau

From: William Lehr, on behalf of AT&T

DATE: August 4, 1997

Exhibits 1 and 2 of my affidavit illustrate that a foreign carrier with a US-based subsidiary has both the incentive and ability to execute an anticompetitive "price squeeze."<sup>1</sup> The example showed that a foreign carrier would find it profitable to enter the US market and to lower prices in order to stimulate additional settlement subsidies for the foreign parent. On a consolidated basis, the foregone profits of the US-based subsidiary are more than offset by the increased settlement subsidies. Along its affiliated route, the integrated foreign carrier is unique in its ability to profit from a strategy that inflicts

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<sup>1</sup> This strategy is a price squeeze in the sense that the integrated foreign carrier has an unfair cost advantage relative to all other competitors along the route between the US and the foreign carrier's home market. This cost advantage is associated with the fact that settlement rates are significantly above costs and that these settlement rates are associated with bottleneck facilities controlled by the foreign carrier. These excess settlement rates permit the integrated foreign carrier to cross-subsidize anticompetitive activities that are harmful to all other competitors along the route and may be used to finance entry to US markets, to leverage and extend its market power, and to raise rivals' costs. I place "price squeeze" in quotes because the strategy is not identical to a classical price squeeze in which an upstream monopolist prices a bottleneck facility at a higher price to non-affiliated downstream subsidiaries than it charges its own subsidiary in order to capture additional profits in the downstream market. The present case is different because (1) the downstream subsidiary also must pay the increased settlement price; (2) the settlement rate cannot be unilaterally changed by the upstream monopolist and, (3) the goal of the strategy is not limited to capturing increased profits in the downstream market. The FCC recognized the first point when it referred to the strategy as a semi-squeeze." The second point is important because settlement rates are the consequence of historical negotiations. While the foreign carrier may not be able to increase settlement rates, the foreign carrier can prevent settlement rates from decreasing. If the settlement rate is held constant, then the only way to increase the settlement subsidy is to increase the flow of net outbound minutes. The anticompetitive "price squeeze" strategy discussed here offers such an approach. Finally, the third point is important in light of on-going efforts to increase competition in foreign markets. Foreign carriers would find it advantageous to harm US IXCs (among the most likely candidates to offer increased competition) and to argue that US long domestic and international long distance services are presently earning substantial excess profits. If accepted this latter argument will deflect attention from promoting competition in foreign markets.

losses on incumbents or other entrants to this market. Moreover, the profitability of this anticompetitive strategy is not affected by the mode of market entry.

To address this problem, I recommended in my affidavit that the FCC require that settlement rates be moved to cost (*i.e.*, the lower bound of the benchmark range proposed in the FCC's benchmark settlement order) as a precondition for foreign entry; and that this condition be applied both to switched resale entry and to facilities-based entry. Adoption of this condition is necessary in order to protect the competitive process and encourage efficient competitive entry by all potential carriers interested in serving that market.

My example was designed to present the general argument as clearly and succinctly as possible. To enhance its generality, I chose to use numerical estimates for prices, costs, and the volume of outbound minutes that are suggestive of, but not identical to those charged in any specific market. Furthermore I ignored return traffic and assumed a competitive equilibrium in the base case in order to reduce the number of parameters included in the example. I explain below why the simplifying assumptions made in my example do not affect the overall conclusion reached in my affidavit.

*i. Base case assumption that the market is at a competitive equilibrium*

By assuming that the US market was initially at a competitive equilibrium (*i.e.*, prices are equal to long-run economic costs), I am able to infer the equilibrium wholesale and retail prices<sup>2</sup> and assure that any price cut by the foreign subsidiary will be below cost.

The relative competitiveness of the US international market is not the issue here: permitting anticompetitive behavior is not the optimal response to promote competition. Anticompetitive behavior by a dominant carrier harms all competition and cannot be the appropriate mechanism for making a market more competitive; moreover, if US international markets are already vigorously competitive, then allowing the foreign carrier the opportunity to implement a price squeeze strategy will harm the competitive process. Finally, while successful implementation of this

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<sup>2</sup> Competitive wholesale price = wholesale costs + settlement costs = \$0.10 + \$0.25 = \$0.35; Competitive retail price = wholesale costs + retail costs + settlement costs = \$0.10 + \$0.05 + \$0.25 = \$0.40.

strategy will lower prices along the affiliated route, prices will fall by less than the amount they would fall if settlement rates were moved to cost.

Therefore, the assumption that markets are initially at a competitive equilibrium is innocuous and correctly focuses attention away from an empirical issue that is irrelevant to the underlying argument. In any case, while I have not conducted a detailed empirical assessment of international competition, I believe available evidence suggests a presumption of effective competition is reasonable.<sup>3</sup>

*ii. Assumption that US carriers would match a below-cost price cut by a US foreign subsidiary*

The example assumes that US carriers would seek to match a price cut by the foreign subsidiary. If this were not the case, then the final market share of the foreign subsidiary would increase substantially. In my simple example, as the market share of the foreign subsidiary increases the foreign subsidiary bears a greater share of the losses imposed on the US industry. This reduces the gains from stimulating incremental settlement subsidies. However, the foreign carrier has multiple incentives to engage in anticompetitive practices. In addition to generating incremental settlement subsidies, the foreign carrier may be interested in subsidizing its entry into US markets more broadly -- using anticompetitive pricing along the affiliated route in order to capture a larger share of US outbound customers overall share of telecommunications service revenues.<sup>4</sup> Or, the foreign carrier may be motivated by a desire to raise rivals' costs and thereby reduce the threat to monopoly profits being earned in the carrier's home market.

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<sup>3</sup> US international markets inherit the competitiveness of US long distance markets. The presence of excess capacity, numerous facilities-based and non-facilities-based competitors and the ready availability of bulk transport capacity guarantee that entry costs are low and long-distance costs are competitive. If wholesale markets are competitive, then retail markets must be competitive also; and if the gap between retail prices and wholesale prices appears large it is because of excessive settlements and because of the high costs of acquiring customers in international markets. One would expect international marketing costs to be significantly larger than domestic marketing costs because international markets are smaller (i.e., reduced scale economies), because uncollectible problems are larger, etc.

<sup>4</sup> Under the FCC's current proposal, the dominant foreign carrier is the only firm able to take advantage of these excess settlement subsidies and thereby gains a regulatory-induced artificial advantage over all other competitors. This is anticompetitive.

Furthermore, in the short-run, incremental costs are significantly below long-run incremental costs, and hence, the cost-threshold below which US carriers would find it unprofitable in the short-run to match a price cut is significantly lower than the level assumed in the example. However, any price cut below long-run economic costs would incur losses that are not sustainable in a long-run competitive equilibrium.

Finally, if demand is sufficiently elastic, the foreign subsidiary may find it rational to lower outbound prices in order to stimulate incremental settlements subsidies even if other US firms fail to match its price cut.

*iii. Assumption that the foreign subsidiary captures only 10% of the market*

If US competitors match the price cut by the foreign subsidiary (as argued above) then the foreign subsidiary's market share is unlikely to increase. Because the attractiveness of the strategy is inversely related to the market share necessary to induce below-cost pricing in the US international market along the route, the carrier would not be interested in acquiring a larger market share.

On the other hand, if the foreign subsidiary is interested and able to capture a significantly larger market share then its motivation may be for one of the other anticompetitive reasons suggested above. In any case, subsidizing price reductions from inefficient subsidies is not pro-competitive.

*iv. Example excluded the effects of return traffic*

In my original example, I ignored the effects of return traffic. In order to include the effects of return traffic, one must estimate the cross-price elasticity of return traffic when the price for US outbound traffic is reduced. Presumably, outbound and return traffic are complements. Therefore, in order to include the effects of return traffic one needs to assume a price for foreign-originated minutes and the cross-price elasticity for inbound minutes as a result of a reduction in the US outbound price.

Including return traffic significantly increases the complexity of the example, but does not affect the overall conclusion that the integrated foreign carrier has

an incentive to execute an anticompetitive price squeeze strategy. To understand how this is the case, consider the following modifications to the example in Exhibit 2 of my affidavit:

- Assume that in the base case, there are 500,000 return minutes;
- that the foreign retail price is \$0.60 per minute (or, 50% higher than the US price); and,
- that the cross-price elasticity is zero so that return traffic is unaffected by a US price cut.

With these changes, the price squeeze strategy is even more attractive, resulting in a 52% increase in excess profits for the consolidated carrier of \$22,000 from \$14,500 in the original example (see Exhibit 2a).<sup>5</sup> If I assume that the cross-price elasticity is sufficiently high that return traffic increases by the same proportional amount as originating traffic<sup>6</sup>, then the gains to the foreign carrier are even larger, or \$40,812 (see Exhibit 2b).

Note that with these changes it appears as if the US industry is initially earning excess profits of \$75,000 - - or, that the US market is not at a competitive equilibrium prior to entry. Even if this were the case, however, observe that the US industry still suffers anticompetitive losses and that these losses would not disappear unless the cross-price elasticity is unreasonably large.<sup>7</sup>

Furthermore, US carriers do take into account return traffic when setting prices for outbound calls. Because of return traffic, the effective settlement rate per outbound minute is less than the accounting rate. In a competitive equilibrium that properly accounted for return traffic, prices would be lower: \$0.275 per minute for

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<sup>5</sup> Exhibit 2d reflects an extension of Exhibit 2. Numbers which change from the original example are highlighted in bold. For example, wholesale costs for US firms increase because of the cost of terminating the return traffic; wholesale, retail and settlement costs increase for the foreign carrier because the return traffic originated abroad.

<sup>6</sup> With an elasticity of 0.7, the 25% price cut results in a 17.5% increase in outbound traffic. Accordingly, return traffic also increases by 17.5%.

<sup>7</sup> Each return minute earns a net settlement subsidy of \$0.15 (= settlement rate minus wholesale cost of termination). In order to eliminate the loss of \$38,250 sustained in Exhibit 2a, the US price cut would need to stimulate 255,000 incremental return minutes -- or, an increase of 51%, which is larger than the direct effect on outbound minutes!

wholesale and \$0.325 for retail.<sup>8</sup> If these corrected prices are included in Exhibit 2a, the competitive base case is restored and the addition of return traffic results in significantly larger losses for US-based firms and a larger gain for the foreign carrier relative to the original example included in my affidavit (see Exhibit 2c).

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<sup>8</sup> Each minute of outbound traffic must pay a gross settlement of \$0.25 per minute. This payment is offset by return traffic which earns a net settlement of \$0.15 per minute (= \$0.25 settlement minus \$0.10 termination costs). Because there are .5 return minutes for each outgoing minute, the effective settlement rate is \$0.175 (= \$0.25 - \$0.15\*.5). Therefore, the competitive retail price is equal to \$0.325 per minute (= \$0.10 wholesale costs per outbound minute + \$0.05 retail costs per outbound minute + \$0.175 effective settlement rate per outbound minute).

## Exhibit 2: Market Impact of Foreign Entry

*"Foreign carrier acquires 10% of US market and stimulates \$0.10 per minute price cut"*

	Base case: before entry		Post-entry: after price cut		
	US industry	Foreign Carrier	US industry (except foreign sub)	US-based foreign subsidiary	Foreign carrier
<b>Revenues</b>					
Outbound traffic	\$400,000		\$317,250	\$ 35,250	
Settlements		\$250,000			\$293,750
Resale revenue					
<b>Costs</b>					
Wholesale costs	\$100,000	\$100,000	\$105,750	\$ 11,750	\$117,500
Retail-level costs	\$ 50,000		\$ 52,875	\$ 5,875	
Settlements	\$250,000		\$264,375	\$ 29,375	
Reseller costs					
<b>Total Costs</b>	\$400,000	\$100,000	\$423,000	\$ 47,000	\$117,500
<b>Excess profit(loss)</b>	\$0	\$150,000	(\$105,750)	(\$ 11,750)	\$176,250
<b>Net effect of strategy on consolidated foreign carrier</b>					\$ 14,500
<b>Assumptions:</b>					
Minutes outbound <sup>9</sup>	1,000,000		1,057,500	117,500	
Wholesale costs <sup>10</sup>	\$0.10				
Retail-level costs <sup>10</sup>	\$0.05				
Settlement rate <sup>10</sup>	\$0.25				
Wholesale price <sup>10</sup>	\$0.35				
Resale price <sup>10</sup>	\$0.40		\$0.30		
Elasticity	0.7				
Share US Market	100%		90%	10%	

<sup>9</sup> Price cut of \$0.10 is 25% price cut. With elasticity of 0.7, this stimulates 175,000 additional minutes. For ease of computation this example ignores inbound traffic.

<sup>10</sup> Per minute.

**Exhibit 3 : Market Impact of Foreign Entry via resale**  
**"Foreign carrier acquires 10% of US market and stimulates \$0.10 per minute price cut"**

	Base case: before entry		Post-entry: after price cut entry via resale		
	US industry	Foreign Carrier	US industry (except foreign sub)	US-based foreign subsidiary	Foreign carrier
<b>Revenues</b>					
Outbound traffic	\$400,000		\$317,250	\$ 35,250	
Settlements		\$250,000			\$293,750
Resale revenue			\$41,125		
<b>Costs</b>					
Wholesale costs	\$100,000	\$100,000	\$117,500		\$117,500
Retail-level costs	\$ 50,000		\$ 52,875	\$ 5,875	
Settlements	\$250,000		\$293,750		
Reseller costs				\$ 41,125	
<b>Total Costs</b>	\$400,000	\$100,000	\$464,125	\$ 47,000	\$117,500
<b>Excess profit(loss)</b>	\$0	\$150,000	(\$105,750)	(\$ 11,750)	\$176,250
<b>Net effect of strategy on consolidated foreign carrier</b>					\$ 14,500
<b>Assumptions:</b>					
Minutes outbound <sup>11</sup>	1,000,000		1,057,500	117,500	
Wholesale costs <sup>12</sup>	\$0.10				
Retail-level costs <sup>10</sup>	\$0.05				
Settlement rate <sup>10</sup>	\$0.25				
Wholesale price <sup>10</sup>	\$0.35				
Resale price <sup>10</sup>	\$0.40		\$0.30		
Elasticity	0.7				
Share US Market	100%		90%	10%	

<sup>11</sup> Price cut of \$0.10 is 25% price cut. With elasticity of 0.7, this stimulates 175,000 additional minutes. For ease of computation this example ignores inbound traffic.

<sup>12</sup> Per minute.

Exhibit 2a: Market Impact of Foreign Entry (with return traffic)<sup>13</sup>

"Foreign carrier acquires 10% of US market and stimulates \$0.10 per minute price cut"

	Base case: before entry		Post-entry: after price cut		
	US industry	Foreign Carrier	US industry (except foreign sub)	US-based foreign subsidiary	Foreign carrier
<b>Revenues</b>					
Outbound traffic	\$400,000	\$300,000	\$317,250	\$ 35,250	\$300,000
Settlements	\$125,000	\$250,000	\$112,750	\$ 12,500	\$293,750
Resale revenue					
<b>Costs</b>					
Wholesale costs <sup>14</sup>	\$150,000	\$150,000	\$150,750	\$ 16,750	\$167,500
Retail-level costs	\$ 50,000	\$25,000	\$ 52,875	\$ 5,875	\$ 25,000
Settlements	\$250,000	\$125,000	\$264,375	\$ 29,375	\$125,000
Reseller costs					
<b>Total Costs</b>	<b>\$450,000</b>	<b>\$300,000</b>	<b>\$468,000</b>	<b>\$ 52,000</b>	<b>\$317,500</b>
<b>Excess profit(loss)</b>	<b>\$75,000</b>	<b>\$250,000</b>	<b>(\$38,250)</b>	<b>(\$ 4,250)</b>	<b>\$276,250</b>
<b>Net effect of strategy on consolidated foreign carrier</b>					<b>\$ 22,000</b>
<b>Assumptions:</b>					
Minutes outbound <sup>15</sup>	1,000,000		1,057,500	117,500	
Wholesale costs <sup>16</sup>	\$0.10				
Retail-level costs <sup>10</sup>	\$0.05				
Settlement rate <sup>10</sup>	\$0.25				
Wholesale price <sup>10</sup>	\$0.35				
Retail price <sup>10</sup>	\$0.40		\$0.30		
Elasticity	0.7				
Share US Market	100%		90%	10%	
Minutes Inbound	500,000		450,000	50,000	
Foreign retail price	\$0.60				

<sup>13</sup> Assume 500,000 minutes return traffic. Retail price cut in U.S. does not affect return traffic.

<sup>14</sup> Includes costs for originating/processing outbound minutes and to terminate inbound minutes.

<sup>15</sup> Price cut of \$0.10 is 25% price cut. With elasticity of 0.7, this stimulates 175,000 additional minutes.

<sup>16</sup> Per minute.

Exhibit 2b: Market Impact of Foreign Entry (with return traffic)<sup>17</sup>

"Foreign carrier acquires 10% of US market and stimulates \$0.10 per minute price cut"

	Base case: before entry		Post-entry: after price cut		
	US industry	Foreign Carrier	US industry (except foreign sub)	US-based foreign subsidiary	Foreign carrier
<b>Revenues</b>					
Outbound traffic	\$400,000	\$300,000	\$317,250	\$ 35,250	\$352,500
Settlements	\$125,000	\$250,000	\$132,188	\$ 14,688	\$293,750
Resale revenue					
<b>Costs</b>					
Wholesale costs	\$150,000	\$150,000	\$158,625	\$ 17,625	\$176,250
Retail-level costs	\$ 50,000	\$25,000	\$ 52,875	\$ 5,875	\$ 29,375
Settlements	\$250,000	\$125,000	\$264,375	\$ 29,375	\$146,875
Reseller costs					
<b>Total Costs</b>	<b>\$450,000</b>	<b>\$300,000</b>	<b>\$475,875</b>	<b>\$ 52,875</b>	<b>\$352,500</b>
<b>Excess profit(loss)</b>	<b>\$75,000</b>	<b>\$250,000</b>	<b>(\$26,437)</b>	<b>(\$ 2,937)</b>	<b>\$293,750</b>
<b>Net effect of strategy on consolidated foreign carrier</b>					<b>\$ 40,812</b>
<b>Assumptions:</b>					
Minutes outbound <sup>18</sup>	1,000,000		1,057,500	117,500	
Wholesale costs <sup>19</sup>	\$0.10				
Retail-level costs <sup>10</sup>	\$0.05				
Settlement rate <sup>10</sup>	\$0.25				
Wholesale price <sup>10</sup>	\$0.35				
Retail price <sup>10</sup>	\$0.40		\$0.30		
Elasticity	0.7				
Share US Market	100%		90%	10%	
Minutes Inbound	500,000		528,750	58,750	
Foreign retail price	\$0.60				

<sup>17</sup> Assume 500,000 minutes return traffic. Retail price cut in U.S. stimulates the same percentage increase in outbound and return minutes.

<sup>18</sup> Price cut of \$0.10 is 25% price cut. With elasticity of 0.7, this stimulates 175,000 additional minutes.

<sup>19</sup> Per minute.

Exhibit 2c: Market Impact of Foreign Entry (with return traffic)<sup>20</sup>

"Foreign carrier acquires 10% of US market and stimulates \$0.10 per minute price cut"

	Base case: before entry		Post-entry: after price cut		
	US industry	Foreign Carrier	US industry (except foreign sub)	US-based foreign subsidiary	Foreign carrier
<b>Revenues</b>					
Outbound traffic	\$325,000	\$300,000	\$246,115	\$ 27,346	\$300,000
Settlements	\$125,000	\$250,000	\$112,500	\$ 12,500	\$303,846
Resale revenue					
<b>Costs</b>					
Wholesale costs <sup>21</sup>	\$150,000	\$150,000	\$154,325	\$ 17,154	\$171,538
Retail-level costs	\$ 50,000	\$25,000	\$ 54,692	\$ 6,077	\$ 25,000
Settlements	\$250,000	\$125,000	\$273,462	\$ 30,385	\$125,000
Reseller costs					
<b>Total Costs</b>	<b>\$450,000</b>	<b>\$300,000</b>	<b>\$482,538</b>	<b>\$ 53,615</b>	<b>\$321,538</b>
<b>Excess profit(loss)</b>	<b>\$0</b>	<b>\$250,000</b>	<b>(\$123,923)</b>	<b>(\$ 13,769)</b>	<b>\$282,308</b>
<b>Net effect of strategy on consolidated foreign carrier</b>					<b>\$ 18,538</b>
<b>Assumptions:</b>					
Minutes outbound <sup>22</sup>	1,000,000		1,093,846	121,538	
Wholesale costs <sup>23</sup>	\$0.10				
Retail-level costs <sup>3</sup>	\$0.05				
Settlement rate <sup>3</sup>	\$0.25				
Wholesale price <sup>3</sup>	\$0.275				
Retail price <sup>3</sup>	\$0.325		\$0.225		
Elasticity	0.7				
Share US Market	100%		90%	10%	
Minutes Inbound	500,000		450,000	50,000	
Foreign retail price	\$0.60				

<sup>20</sup> Assume 500,000 minutes return traffic. Retail price cut in U.S. does not affect return traffic.

<sup>21</sup> Includes costs for originating/processing outbound minutes and to terminate inbound minutes.

<sup>22</sup> Price cut of \$0.10 is 31% price cut (because initial price is lower). With elasticity of 0.7, this stimulates 307,692 additional minutes.

<sup>23</sup> Per minute.