DOCKET FILE COPY ORIGINAL

EX PARTE OR LATE FILED

AT&T

**Kristen C. Thatcher**
Manager
Federal Government Affairs

Suite 1000
1120 20th Street, N.W.
Washington, DC 20036
202 457-3883
FAX 202 457-2545
EMAIL thatcher@lgamgw.att.com

October 27, 1997

RECEIVED
OCT 27 1997
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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

Re: Ex Parte Meeting
IB 97-142 - Rules and Policies on Foreign Participation in the U.S. Telecommunications Market

Dear Mr. Caton:

On Friday, October 24, 1997, Larry Lafaro, Jim Talbot and I of AT&T and Marius Schwartz, on behalf of AT&T, met with Diane Cornell, Laurie Sherman, Adam Krinsky, Bob McDonald, John Giusti, Kathy O'Brien an Mark Uretsky of the International Bureau to discuss concerns raised by Cable & Wireless with regard to a Switched Services benchmark entry condition. We also discussed, as attached, ex post conditions in MFN consistency issues.

Because of the lateness of the day two copies of this Notice are being submitted on the following business day to the Secretary of the Federal Communications Commission in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Kristen Thatcher

Attachments

cc: L. Sherman
D. Cornell
A. Krinsky
B. McDonald
K. O'Brien
M. Uretsky
J. Giusti

0+2

Recycled Paper

# Rules and Policies on Foreign Participation in the U.S. Telecommunications Market,

# IB 97-142.

## 1. *Continued Exercise of Commission Authority to Prevent Competitive Harm is Necessary and Consistent with the GATS*

- **The FCC retains the ability to protect competition in the U.S. after Jan. 1, 1998.**

  - "The Executive Branch believes the Commission should examine closely whether the applicant will have the ability and incentive to leverage its market power to distort competition to the detriment of U.S. consumers." (USTR Comments)

  - Determining whether a license applicant has the "ability to distort competition" requires an examination of foreign market conditions, such as:

    - "the absence of a transparent regulatory framework in the foreign market"

    - "the failure of foreign regulations to protect competition"

    - "problems with interconnection for the provision of international services." (USTR Comments)

  - "[T]he possibility that the FCC may deny or condition some foreign carriers' Section 214 or Section 310(b)(4) applications does not establish an MFN or national treatment violation. Indeed, the possibility that potential market participants may be denied entry, or that their entry may be conditioned, is inherent in the exercise of any licensing system." (USTR Reply Comments)

  - Both the Commission (*Foreign Carrier Entry Order* and *Sprint*) and DOJ (*BT I* and *Sprint*) have upheld the conditioning or denial of licenses where post-entry safeguards did not protect competition in the U.S. market.

- **GATS will not provide sufficient market-opening to prevent abuse of market power.**

  - Only 20 WTO Member countries' GATS commitments meet ECO as of Jan. 1, 1998

  - Approx. 60 WTO Member countries have made no commitments.

- **The proposed "very high risk of harm" standard is not required by the GATS.**

  - The Commission should maintain the long-established "substantial risk" standard.

  - The U.S. practice has been to make only those changes in law and regulation that are strictly required by WTO agreements.

## 2. *Appropriate Settlement Rate Entry Conditions Are Required to Prevent Competitive Harm*

- **The ownership of facilities is not determinative of market success. Resale entry provides the same advantages as facilities-based entry for the provision of U.S. international and long-distance services.**

  *The same relationships with customers:*

  - Terminating access to every telephone number in the U.S.
  - Equal access to all U.S. customers
  - Credit card availability

  *The same technical capabilities:*

  - Trunk side access
  - 1+ dialing capability (own PIC)
  - Non-discriminatory interconnection terms
  - Control over software-defined network (SDN) features
  - Advanced features (customized billing, custom calling/dialing features)
  - Technical support by underlying carrier

  *Low costs:*

  - Significant volume discounts are widely available to resellers
  - Price protection due to intense competition at the wholesale level
  - Facilities-based carriers sell wholesale services at prices that barely recover cost; it is widely recognized that margins on these services are extremely low

- **For foreign carriers, resale will be the preferred means of entry as it is easier, quicker and cheaper than facilities-based entry.**

  - Easy start-up
  - No capital investment requirement for facilities, switches, billing systems
  - No special technical background necessary
  - Ability to start in small niche markets, and grow
  - Few regulatory requirements
  - Billing and collections by underlying carrier

- There are over 500 resellers operating in the U.S. today, many of them providing international switched resale services. As recognized by the FCC in the *AT&T Non-Dominance Order* (¶ 61), resellers put downward pressure on prices in the long-distance market.

- "*I believe the most profound change in the next decade in the way local, long-distance, video and wireless companies provide service will be a shift from almost total reliance on their own facility-based network to reliance on reselling someone else's network or spectrum.*" (Dr. Jerry Lucas, Publisher, Billing World, Sep./Oct. 1995)

- **A foreign-affiliated carrier with above-cost settlement rates can obtain additional monopoly profits and raise rivals' costs in the U.S. just as easily by providing U.S. international services through switched resale as through facilities-based authorization.**

    - Switched resale, like the provision of facilities-based services, allows manipulation of the settlements and proportionate return process -- e.g., through "affiliate call-turnaround," "affiliate reorigination," or "call volume enhancement."

- **Detection of settlements manipulation and market distortion is just as difficult with switched resale services as with facilities-based services.**

    - Settlements manipulation by switched resale, as with facilities-based services, is inherently difficult to detect.

    - Reseller costs are difficult to audit because resellers typically purchase by private contract under complex arrangements frequently involving term commitments and scale discounts. In addition, resale services are purchased from numerous carriers on a "least cost routing" basis, frequently at "spot" prices that change rapidly in response to market conditions (e.g., excess capacity). Other variables that preclude easy monitoring include frequent reseller leasing or ownership of switches and/or transmission capabilities for the provision of certain elements of their services.

- **The conclusions of the *Benchmark Order* concerning the need for a benchmark condition for facilities-based services apply to switched resale.**

  - "[A] foreign-affiliated carrier can engage in price squeeze behavior on the affiliated route by virtue of its dual role as a provider of an above-cost essential input and a competitor in the retail market using that input." (*Benchmark Order*, ¶ 219)

  - The same conclusions regarding the necessity of (1) the benchmark condition, as a preventive measure, and (2) the bright line pricing test, apply to switched resale:

    - same ability and incentive to price squeeze to generate additional settlement payments, as found by the following 1996 Commission Orders on switched resale:

    - "Although theoretically Telstra, Inc. might have the ability to price squeeze other carriers on this route (i.e., pricing U.S. resold services at or even below cost in order to generate significant settlement payments to its foreign carrier affiliate), historically traffic volumes are extremely low, and we find no substantial community of interest exists for making calls to Kiribati for which Telstra, Inc.'s affiliate would receive settlement payments." (*Telstra, Inc.*, ITC-96-443)

    - "GTE could maximize its overall profits by pricing GTE Telecom's U.S. resold switched services at or even below cost in order to generate significant settlement payments to its foreign carrier affiliates." (*GTE Telecom Inc.*, ITC-95-443)

  - The existence of an above-cost settlement rate provides the same incentive, requiring imposition of the benchmark condition, irrespective of the type of service provided in the U.S. by the foreign carrier.

  - There is the same ability to price below average variable cost to generate additional traffic (and settlements payments) on the affiliated route.

### 3. *Stronger Post-Entry Safeguards Are Necessary*

- **All carriers with foreign market power should be subject to the "no special concessions" requirement and basic dominant carrier safeguards -- even if the foreign market is open to competition.**

  - MCI and BTNA's claim that the "no special concessions" requirement should not apply to open foreign markets would allow preferential arrangements that could severely disadvantage other U.S. carriers.

- **Minor modifications to the proposed basic dominant carrier rules are required to assist the detection of anticompetitive conduct.**

  - There should be notification of each circuit addition or discontinuation with specification of the relevant facility.

  - Quarterly traffic and revenue reports should report separately originating and terminating traffic and traffic subject to different settlement rates, and should clearly identify the minutes included and excluded from proportionate return.

- **The supplemental dominant carrier safeguards should also apply where the foreign market does not provide fair rules of competition.**

  - They should also apply for countries without fair rules of competition (i.e., insufficient compliance with GATS Reference Paper) or where foreign control of facilities-based carriers is precluded (e.g., Mexico).

    - Without these requirements, U.S. carriers cannot protect themselves against discrimination in the foreign country.

- **Additional supplemental dominant carrier safeguards are also required.**

  - The *Benchmark Order* finds a greater risk of anticompetitive conduct on international routes than in domestic long-distance.

  - The RBOCs will be subject to requirements for the disclosure of affiliate transactions, structural separation and accelerated complaint procedures when they enter in-region long-distance markets.

    - These requirements should also apply to carriers with market power in closed foreign markets.

  - *Full disclosure of affiliate transactions*: Quarterly summaries of provisioning and maintenance records (proposed by NPRM) are not adequate. The RBOCs are required to place full details of affiliate transactions on the Internet within 10 days.

    -- The U.S. affiliate should be required to file monthly reports showing the prices, terms and conditions of all products and services provided by its affiliated foreign carrier, settlement rates and the methodology for proportionate return, the types of circuits and services provided, the average time intervals between order and delivery, the number of outages and intervals between fault report and service restoration, and, for circuits used to provide international switched services, the average number of circuit equivalents available to the U.S. affiliate and the percentage of 'busy hour' calls that failed to complete.

  - *Structural separation*: As with the RBOCs (Sect. 272 (b)) this should require separate officers, directors and employees; separate accounts; and no investment not recorded as debt or equity.

  - *Expedited complaint procedures*: The 90 day procedures established for the RBOCs are equally necessary here.

  - To assist monitoring, there should be easier carrier access to this information.

## 4. *Proponents of Flexibility Arrangements Should be Required to Put Forward Evidence Concerning Foreign Market Conditions.*

- **A presumption in favor of flexible arrangements would make it more difficult to prevent discrimination.**

  - The proponent has superior access to the relevant information and should be required to show that market conditions are sufficiently competitive.

TO: FCC International Bureau

From: William Lehr, on behalf of AT&T

DATE: October 23, 1997

The purpose of this memorandum is to respond to misleading and incorrect statements included in the ex parte presentation from Cable and Wireless[1] that were intended to rebut my earlier testimony[2]. Nothing in the C&W comments causes me to revise my earlier position regarding the advisability of the FCC adopting a requirement that settlement rates be moved to economic costs as a precondition for approving foreign entry (both facilities-based and as a reseller).

My surrebuttal comments are divided into two parts. First, I explain why the overall tone and conclusion of the C&W comments are misleading in characterizing the resale entry precondition as harmful to competition. Second, I respond to the major criticisms raised by C&W to my earlier testimony.

*i. Resale entry restriction is internally consistent and pro-competitive, contrary to characterization in C&W comments*

The C&W comments are misleading, logically inconsistent and incorrect. They characterize the recommendation that resale entry under Section 214 be conditional on settlements being within the benchmark range as "draconian,"[3] as likely to "have a significant adverse impact on consumers by affecting existing and potential competition in the U.S. and foreign markets"[4] and as "inconsistent with other FCC policies."[5] These are gross misrepresentations of the facts in this case.

---

1 See *Ex Parte Presentation by Cable & Wireless, Inc., in the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market*, before the Federal Communications Commission, IB Docket No. 97-142, October 10, 1997 (hereafter referred to as "C&W Comments").

2 See *Affidavit of William H. Lehr on Behalf of AT&T*, in the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market, before the Federal Communications Commission, IB Docket No. 97-142, July 1997 (hereafter referred to as "Lehr Affidavit"); and *Ex parte letter from William Lehr to the FCC*, included as Attachment #2 to *Reply Comments of AT&T*, in the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market, before the Federal Communications Commission, IB Docket No. 97-142, August 12, 1997 (hereafter referred to as "Lehr Ex Parte").

3 See C&W Comments, note 1, *supra*, page 9.

4 See C&W Comments, note 1, *supra*, page 3.

5 See C&W Comments, note 1, *supra*, page 18. For example, the C&W comments claim that the resale entry condition is not consistent with FCC domestic policy because interstate domestic access charges remain above cost. While it is true that access charges are currently above cost,

The FCC's proposed foreign entry order[6] anticipates a significant liberalization of current foreign entry requirements in the interests of promoting international competition. In order for international competition to flourish (especially in foreign markets that are still dominated by monopoly carriers), it is essential that settlement rates be moved towards economic costs. Moving settlement rates to economic costs will eliminate the unfair advantage accruing to a dominant incumbent foreign carrier over traffic to and from its affiliated foreign market. This will benefit consumers directly by leading to substantial reductions in international calling rates and by promoting competition. Creating a level playing field will help -- not hinder -- international competition. In recognition of these facts and consistent with its proposal to liberalize foreign entry requirements, the FCC issued its benchmark settlement order calling for reductions in above-cost settlement rates.[7]

The proposal by AT&T to require cost-based settlement rates as a precondition for foreign entry into the U.S. is consistent both with the FCC policy of promoting reductions in settlement rates and with the FCC policy of liberalizing foreign entry restrictions. The AT&T proposal is not "draconian" because it does not *prohibit* entry and applies solely to foreign carriers along their *affiliated route*. The affiliated foreign carrier is unique among potential entrants only with respect to its ability to exploit above-cost settlement rates. The resale entry condition would help to level the playing field among potential entrants into U.S. markets. Such a rule would deter entry only if the foreign carrier intends to exploit above-cost settlement rates, thereby opposing increased international competition and compliance with the FCC's benchmark settlements order. Because the proposed entry pre-condition is pro-competitive, the attempt by C&W to characterize the resale entry precondition as a new regulatory burden is misleading.

---

the amount of the mark-up is significantly smaller than the mark-up of current settlement rates over cost. Furthermore, the Bell Operating Companies (BOC) are prohibited from providing in-region interLATA services until they have fully complied with the pro-competitive policies of the Telecommunications Act of 1996 that are intended to assure the success of local service competition. Moreover, while the FCC has proposed moving access charges toward economic costs, the network unbundling and interconnection provisions required as a precondition for BOC entry into in-region interLATA toll services are significantly more stringent then the proposed resale condition for foreign entry. If anything, the FCC foreign entry proposal with the resale condition included is significantly more liberal than FCC policies towards domestic competition.

[6] See *Order and Proposed Rulemaking in the Matter of Rules and Policies on Foreign Participation in the U.S. Telecommunications Market*, Federal Communications Commission, IB Docket No. 97-142, June 4, 1997 (hereafter reffered to as "FCC foreign entry order").

[7] See *Report and Order in the Matter of International Settlement Rates*, Federal Communications Commission, IB Docket No. 96-261, August 18, 1997 (hereafter referred to as "FCC Benchmark Settlements Order").

*ii. C&W Comments critiquing explanation of anticompetitive threat from foreign entry are misleading and incorrect -- and hence, are irrelevant.*

The C&W comments attempt to rebut the example presented in my earlier testimony illustrating the anticompetitive danger posed by foreign entry in the presence of above-cost settlement rates. These comments are irrelevant because they rely on a mischaracterization and misinterpretation of my analysis.

First, while the desire to maximize the settlement subsidy provides an important rationale for engaging in anticompetitive behavior, it does not provide the "sole plausible basis for imposing a resale Section 214 condition,"[8] as I explained in my earlier testimony.[9] Foreign carriers with a dominant position in their home market have a strong incentive to seek to protect that position and leverage their market power into additional markets. This is rational, profit-maximizing behavior. Anticompetitive behavior of any sort that raises rivals' costs helps to achieve these goals. The desire to protect current monopoly profits or to extend market power over new markets can provide an incentive to engage in anticompetitive strategies that are not profitable in the short-run, but result in higher future profits (relative to what would occur in the absence of the anticompetitive strategy).[10] While the proposed resale entry condition would not eliminate the danger of anticompetitive behavior (and hence, continued post-entry regulatory oversight will remain necessary for some time[11]), it will help reduce the danger from one obvious strategy for harming the competitive process and will encourage movement towards cost-based settlement rates. This will reduce the foreign carrier's ability to engage in other sorts of anticompetitive activity.

The example I presented did not attempt to quantify either the incentives or potential danger to consumers from the desire of foreign incumbents to pursue anticompetitive behavior in order to protect or extend their market power; however, it is not appropriate to dismiss these incentives from consideration. This is an important and delicate time in process of promoting domestic local service competition and greater competition in foreign markets. Anticompetitive behavior that delays realization of these larger goals would result in significantly larger adverse effects for consumers and U.S.-based competitors than are included in the numerical examples presented in my testimony. Excluding estimates of these effects means that my illustrative example of potential consumer losses from anticompetitive behavior are conservative.

---

8 See C&W Comments, note 1, *supra*, page 9.

9 See, for example, Lehr Affidavit, note 2, *supra*, pages 8-9, or Lehr Ex Parte, note 2, *supra*, pages 3-4.

10 A firm which is earning monopoly profits and is faced with competition that may eliminate those profits altogether, would be willing to sacrifice a portion of those profits to deter or delay competition.

11 For example, even if settlement rates are at cost, the foreign carrier may still seek to harm rivals by offering discriminatory interconnection services to unaffiliated carriers.

Second, the C&W comments falsely characterize the example I presented as a classic version of predatory pricing in which "carriers would deliberately incur losses"[12] in order to earn higher future profits. The whole point of the example was that even under extremely conservative assumptions[13], anticompetitive pricing results in immediate profits for the consolidated foreign carrier. There is no period of initial losses that must be recovered by higher prices in the future. The benefits from excess settlement subsidies, *by themselves*, provide sufficient incentive for the reseller to engage in anticompetitive activity. These would be augmented by any benefits associated with raising rivals' costs or from exploiting above-cost pricing for either outbound or return traffic.

Third, the C&W comments presume incorrectly that my example depends on the presumption that U.S. international markets are perfectly competitive. While it is true that my example uses this assumption to illustrate the anticompetitive effect of foreign entry when settlements are above cost, this assumption is made to simplify the analysis and is not essential to the overall conclusion, as I explain in my earlier ex parte communication.[14] Even if one were to accept -- I believe counterfactually -- that U.S. international retail rates are significantly above economic costs (net of settlements), the proposed resale entry condition would remain desirable in order to promote a level playing field for all entrants into the market.[15] Absence of such a requirement would unfairly advantage the affiliated foreign carrier, and consequently, would deter competitive entry from the many other potential entrants who could logically be expected to enter in response to above-cost prices. Moreover, evidence that entry and exit continues to occur in international markets and that there is a large pool of potential entrants that will not be restrained by the proposed resale entry condition suggests that C&W's presumption that U.S. retail rates are currently significantly above competitive levels is unfounded. Neither C&W nor anyone else has provided substantive data to demonstrate that international calling rates from the U.S. (net of settlement payments) are significantly above competitive levels. Proponents of this view appear to rely on misleading comparisons of international and domestic retail tariffs to infer the existence of market power on the part of U.S.-based international service providers. However, the

---

12 See C&W Comments, note 1, *supra*, page 9.

13 That is: (1) ex ante international prices are competitive so *any* price reduction is *prima facie* anticompetitive; (2) ignoring effects of return traffic; and, (3) assuming demand is not very elastic)

14 See Lehr Ex Parte, note 2, *supra*, pages 2-3.

15 A foreign carrier that is able to subsidize price cuts from excess settlement subsidies will have an unfair advantage relative to all other competitors, including carriers which may be more efficient and have lower economic costs (net of settlements) than the affiliated foreign carrier. Reductions in international calling rates that protect above cost settlement rates will deny consumers much more significant price savings and hence reflect a false comparison. If the FCC feels U.S. markets are not effectively competitive, then it should promote efficient entry which means assuring a level playing field.

structural features of the market suggest that entry barriers are low which is inconsistent with the presumption of excess profits.

Fourth, the C&W comments argue that ex post regulatory oversight already provides sufficient protection against anticompetitive behavior. They argue that the foreign carrier would be deterred by "enormous practical and legal risks"[16] from engaging in anticompetitive pricing behavior. This claim is unsubstantiated and is inconsistent with pro-competitive policy which uses the inadequacy of traditional regulatory oversight as a principal justification for the new pro-competitive paradigm. With the liberalization of foreign entry restrictions, such oversight as currently exists will be further relaxed.

C&W trivialize the difficulties of accurately assessing a foreign entrant's true economic costs.[17] Furthermore, it is likely that for U.S. carriers to be able to prove a case of anticompetitive behavior, they will have to refrain from matching the price of the foreign firm, allowing the foreign firm to increase its market share. This places injured U.S. carriers in a *Catch 22* situation: if a U.S. carrier chooses to oppose the anticompetitive threat directly by matching the below-cost pricing[18] it reduces its ability to seek legal remedies; whereas, if it seeks legal remedies it must accept market share losses that may be much more costly to recoup later.[19]

---

16 See C&W Comments, note 1, *supra*, page 10.

17 For example, C&W claim that "the FCC knows, or can readily find out, the wholesale rates that the resale carrier pays to its underlying facilities-based carrier" (see C&W Comments, note 1, *supra*, page 7). First, these costs represent only a portion of the total costs of a reseller. Second, C&W misrepresent the complexity of most reseller facilities purchase arrangements. As C&W point out, resellers often purchase capacity with volume and time commitments as part of complex agreements that make it difficult to assign costs directly to specific services (see C&W Comments, note 1, *supra*, page 3). Third, to the extent there is excess capacity it is possible that a reseller may be able to purchase capacity at less than the long run incremental cost of capacity -- this is one of the reasons resale entry may offer an especially attractive means for implementing an anticompetitive pricing strategy.

18 I assume that this is the case in my earlier testimony and explain why this assumption is reasonable. Moreover, I explain how even if this assumption is relaxed, my overall conclusions remain unchanged (see Lehr Affidavit, note 2, *supra*, pages 19-20, or Lehr Ex Parte, note 2, *supra*, pages 3-4).

19 C&W argue that competitors would always choose to pursue regulatory remedies rather than match a below cost price cut (see C&W Comments, note 1, *supra*, page 12) but elsewhere dispute the likelihood that foreign entrants will be able to attract a significant market share (see C&W Comments, note 1, *supra*, page 13). Their circuitous logic is contradictory. Furthermore, in my earlier testimony, I assumed that the foreign subsidiary would obtain a 10% market share by acquiring a U.S. based carrier, not because of migration of customers in response to lower prices. In fact, the smaller the market share that is sufficient to initiate a price war, the higher the profits from the anticompetitive strategy. Furthermore, all of the numbers in my example were chosen for illustrative purposes that were not intended to replicate actual pricing along any particular

Moreover, C&W argue incorrectly that the FCC can rely on the facilities-provider of the reseller to monitor anticompetitive behavior and to counter below-cost pricing by raising the underlying price for facilities. Because of the intensity of wholesale competition among competing facilities-based providers, the reseller's facilities-provider is unlikely to discipline the reseller for its anticompetitive pricing behavior for fear of losing its business to a competing facilities provider while continuing to suffer the losses imposed by the anticompetitive pricing strategy. Furthermore, in my earlier example, I conservatively assumed that the reseller would bear the full cost of the settlement payments it imposes on the underlying facilities provider.[20] To the extent this is not true, the profits to the integrated foreign carrier from pursuing its anticompetitive pricing strategy are increased beyond those indicated by my example.

Fifth, C&W argue that the threat from resale entry is less than the threat from facilities-based entry.[21] Even if this is true, it is irrelevant. It is noteworthy that C&W do not propose an alternative imputation rule and provide evidence of reliable estimates of reseller costs in order to provide an alternative (and I believe, less effective) alternative to the proposed foreign entry condition. It is precisely because of the difficulties of implementing and enforcing such an imputation rule that I recommend adopting the resale entry condition. Furthermore, as I noted in my earlier testimony[22], reseller entry may offer a more attractive opportunity for implementing the anticompetitive strategy because it offers a more flexible, faster, scaleable, and lower cost entry strategy than facilities-based entry.

---

route. C&W do not provide more realistic estimates, but argue without support that the returns from the anticompetitive strategy are insufficient to warrant the risk.

20 The unit cost of settlements takes into account the effect of return traffic and so is less than the full settlement rate. The unit cost of settlements will increase only if the anticompetitive strategy increases the net share of outbound traffic. (Note that this would not be the case if outbound traffic stimulates a proportionate or larger increase in return traffic.) Even if the share of net outbound traffic were to increase, however, competition among facilities-based providers for the reseller's business may preclude full pass through of any increase in per unit settlements cost because a significant share of the facilities-providers' costs are sunk or fixed. Moreover, to the extent these costs are fixed, scale economies imply that increased traffic would actually lower these costs on a per unit basis.

In my example, I excluded the effects of return traffic in order to simplify the analysis (as explained in Lehr Ex Parte, note 2 *supra*). In order to properly account for the effects of return traffic it would be necessary to account for the significant margins that the foreign carrier earns on return traffic because of its market power in the foreign market. These profits would be likely to more than offset any increase in the foreign reseller subsidiary's costs in the unlikely event that those costs do in fact increase. Inclusion of the effects of return traffic, therefore, would likely increase the projected benefits to the integrated foreign carrier of pursuing the anticompetitive pricing strategy, as I explained earlier.

21 See C&W Comments, note 1, *supra*, page 6.

22 See Lehr Affidavit, note 2, *supra*, pages 17-18.

In addition to the major errors cited above, the C&W comments contain numerous other lesser errors of interpretation, faulty analysis, and attempts to mischaracterize the example presented in my earlier testimony.[23] However, the preceding points should provide sufficient justification for rejecting the C&W critique as irrelevant.

---

23 For example, they argue that "perhaps AT&T would prohibit entry to any carrier receiving investments from any non-U.S. interest" (see C&W Comments, note 1, *supra*, page 12); or later, that "there is no credible means of determining the purpose to which foreign carriers put the revenues they obtain from international settlements" (see C&W Comments, note 1, *supra*, page 14). These and other comments that are similarly hyperbolic or irrelevant serve only to confuse the discussion: the former assigns a position to AT&T that is inconsistent with its obvious position towards liberalizing foreign entry requirements, while the latter is irrelevant as discussed earlier.

## Rules and Policies on Foreign Participation in the U.S. Telecommunications Market,IB 97-142.

### AT&T Response to Major Arguments Made in C&W's Ex Parte Presentation, Oct. 10, 1997

*C&W Claim: a requirement for a benchmark condition "is tantamount to revoking the license altogether, thereby forcing the carrier to exit the market," thus reducing competition in a market that is already "far from competitive (p. 3).*

AT&T response: C&W repeatedly asserts -- without any supporting evidence or explanation -- that a requirement that C&W should implement benchmark settlement rates on the affiliate routes on which it holds Section 214 switched resale authorizations would effectively force it out of business. C&W thus contends that unless its foreign affiliates continue to receive above-cost settlements payments from U.S. carriers, it cannot continue to participate in the U.S. international market.

This is hardly consistent with C&W's claim that the U.S. international market is not competitive, with "considerable scope for price competition." (p. 5). If C&W's second claim was correct (which it is not) and supra-competitive profits were available in the U.S. international services market, C&W, as a well-established market participant providing services on "more than 20 affiliated routes for more than ten years" (p.1), would not require subsidy payments from U.S. carriers and consumers in order to compete in that market.

In any event, there no basis to C&W's claims. In fact, C&W is a highly profitable corporation, as it explains in its 1997 Annual Report (p. 5):

> "[W]e're successful. We have generated over $2 billion in cash this year. Our revenue and earnings per employee are among the highest in the industry. In the past five years, we have virtually doubled our revenues and earnings and dividends have grown at double-digit annual rates. Over this period, the value of our company has increased from approximately 7 billion [UK] pounds to over 11 billion [UK] pounds."

During this same 5 year period (1992-96), C&W's monopoly affiliates in foreign countries have collected total net settlement outpayments from U.S. carriers of more than $1.5 billion -- well over $1 billion of which represents an above-cost subsidy. Indeed, annual U.S. net settlement outpayments to these C&W affiliates are now almost $500 million.

Nor is there any prospect that most of these countries will open their telecommunications markets in the near future. Of the 17 C&W affiliate countries that are WTO Members, only seven made any commitments in the WTO Basic

Telecommunications negotiations and only <u>three</u> committed to open their markets fully: the UK (in 1998); Antigua/Barbuda (in 2012); and Jamaica (in 2013).

C&W also overlooks the fact that the Commission's *Benchmark Order* requires the reduction of its affiliates' present above-cost settlement rates to benchmark levels over the next 1-5 years in any event. For example, U.S. carriers are required to negotiate benchmark rates with Hong Kong, which alone accounts for more than $200 million of the present U.S. outpayment received by C&W affiliates, by January 1, 1999.

*C&W Claim: The lack of any prior instances of predatory pricing by C&W during the 10 years in which it has held international switched resale authorizations on 20 routes demonstrates that anticompetitive conduct will not occur in the future .*

<u>AT&T response</u>: For much of this period, C&W was much more heavily regulated than it is today. Until 1992, <u>all</u> foreign-owned carriers, both resellers and facilities-based carriers, were subject to dominant carrier regulation requiring longer notice periods for tariffs and cost support for tariff filings. This regulation greatly limited C&W's potential ability to engage in anticompetitive behavior.

In more recent years, C&W's presence on affiliate routes has been by virtue of "grandfathering" rather than in conformity with FCC fair market access principles. As one of very few foreign monopolists with Section 214 authorizations, it would have been surprising if C&W had attempted to engage in anticompetitive pricing actions as any such actions would have been quickly scrutinized by competitors and the Commission. However, the same considerations may not apply in a situation of potentially widespread U.S. market entry by foreign monopolists post-1998, particularly if there are only limited safeguards against such misbehavior.

*<u>C&W claim</u>: Any attempt to engage in a "below cost pricing scheme" would result in "immediate detection by U.SW. carriers and the FCC." (p. 10)*

<u>AT&T response</u>: In fact, reseller costs are difficult to audit because resellers typically purchase by private contract under complex arrangements frequently involving term commitments and scale discounts. In addition, resale services are purchased from numerous carriers on a "least cost routing" basis, frequently at "spot" prices that change rapidly in response to market conditions. Other variables that preclude easy monitoring include frequent reseller leasing or ownership of switches and/or transmission capabilities

# CABLE & WIRELESS

| COUNTRY | BM Rate (Year) | 1997 Settlement Rate | MONOPOLY | WTO MEMBER | GATS OFFER MADE | OPEN MARKET OFFER (1) |
|---|---|---|---|---|---|---|
| Anguilla | | $.455 | X | | | |
| Antigua/Barbuda | $.19 (2000) | $.455 | X | X | Yes | 2012 |
| Ascension Is. | | $1.00 | X | | | |
| Barbados | $.19 (2000) | $.525 | X | X | No | |
| Bermuda | $.15 (1999) | $.350 | | | | |
| British Virgin Is. | | $.455 | X | | | |
| Cayman Is. | $.15 (1999) | $.455 | X | | | |
| Diego Garcia | | $.450 | X | | | |
| Dominica | $.19 (2001) | $.455 | X | X | Yes | No |
| Falkland Is. | | $1.00 | X | | | |
| Fiji | $.19 (2001) | $.950 | X | X | No | |
| Grenada | $.19 (2001) | $.455 | X | X | No | |
| Hong Kong | $.15 (1999) | $.393 | X | X | Yes | No |
| Jamaica | $.19 (2001) | $.625 | X | X | Yes | 2013 |
| Latvia | $.19 (2001) | $.881 | X | ** | | |
| Macau | $.15 (1999) | $.650 | X | X | No | |
| Maldives | $.19 (2001) | $1.25 | X | X | No | |
| Montserrat | | $.455 | X | | | |
| Panama | $.19 (2001) | $.600 | X | (2) | | |
| Philippines | $.19 (2001) | $.500 | | X | Yes | No |
| Russia* | $.19 (2001) | $..583/$1.12 | | ** | | |
| Seychelles | $.19 (2000) | $1.25 | X | ** | | |
| Sierra Leone | $.23 (2003) | $.750 | X | X | No | |
| Solomon Is. | | $1.00 | X | X | No | |
| St. Helena | | $1.00 | X | | | |
| St. Kitts/Nevis | $.19 (2000) | $.455 | X | X | No | |
| St. Lucia | $.19 (2000) | $.455 | X | X | No | |
| St. Vincent/Grenadines | $.19 (2001) | $.455 | X | X | No | |
| Tonga | $.19 (2001) | $1.00 | X | ** | | |
| Trinidad/Tobago | $.19 (2000) | $.575 | X | X | Yes | No |
| Turks + Caicos Is. | | $.455 | X | | | |
| United Kingdom | $.15 (1999) | $.28/$.07 | | X | Yes | 1/1/98 |
| Vanuatu | $.19 (2001) | $2.00 | X | ** | | |
| Yemen | $.23 (2002) | $.750 | X | | | |

* C&W has an affiliation with more than one carrier in Russia

(1) An open market offer has these characteristics:
- No restrictions on provision of facilities-based international voice services
- No restrictions on foreign control of international facilities-based operators
- Endorsement of relevant parts of the WTO Reference Paper (nondiscriminatory interconnection, independent regulator and competitive safeguards)

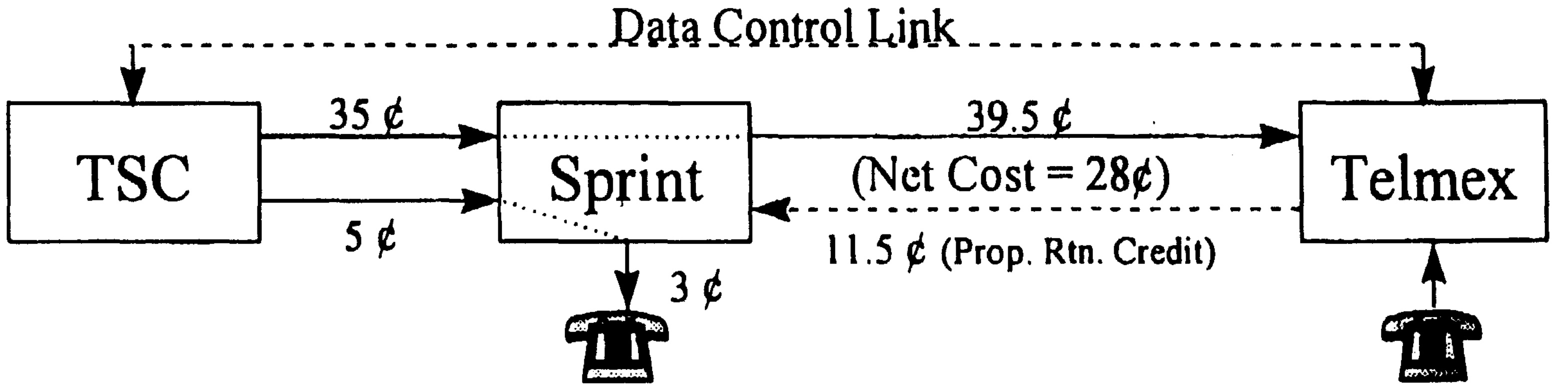
(2) Panama was not a WTO member at the time of the GATS negotiations, nor has it made an offer since joining in September 1997. News stories indicate that plans are to open the market to competition in 2003.

** Presently negotiating WTO membership.

1997 Settlement Rate data source: FCC Accounting Rates for IMTS of the U.S., 10/1/97

10/22/97

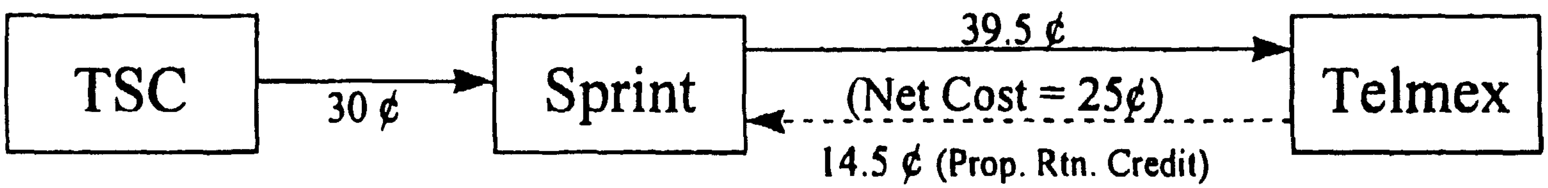
# Affiliate Call Turnaround




| | Before | After | Net Impact |
|---|---|---|---|
| Telmex | • 2,500M Southbound Minutes | • 2,700M Southbound Minutes | |
| | • 1,000M Northbound Minutes | • 800M Northbound Minutes | Gain of $72M |
| | • $593M Net Settlements Revenue | • $751M Net Settlements Revenue | |
| | | • $86M Paid to TSC to Cover Costs | |
| Sprint | • 275M Southbound Minutes | • 475M Southbound Minutes | |
| | • 110M Northbound Minutes | • 141M Northbound Minutes | Gain of $6M |
| | • $65M Net Settlements Outpayment | • $132M Net Settlements Outpayment | |
| | | • $70M International Wholesale Revenue | |
| | | • $10M Domestic Wholesale Revenue | |
| | | • $7M Additional Access Charges | |
| TSC | • N/A | • 200M Foreign Resold Minutes | |
| | | • 200M U.S. Resold Minutes | Gain of $6M |
| | | • $70M International Wholesale Cost | |
| | | • $10M Domestic Wholesale Cost | |
| | | • $86M Reimbursement from Telmex | |
| Other U.S. Carriers | • 2,225M Southbound Minutes | • 2,225M Southbound Minutes | |
| | • 890M Northbound Minutes | • 659M Northbound Minutes | Loss of $84M |
| | • $528M Net Settlements Outpayment | • $619M Net Settlements Outpayment | |
| | | • $7M Savings in Access Charges | |

- Using CTA technology, Telmex (with TSC) turns 200M N/B minutes into S/B minutes; Increases US outpayment by $158M
- TSC pays Sprint 35¢/minute for Int'l link and 5¢/minute for domestic termination
- Sprint receives a net addition of 31M N/B minutes due to "market share" growth
- Telmex reimburses TSC 43¢/minute to cover costs

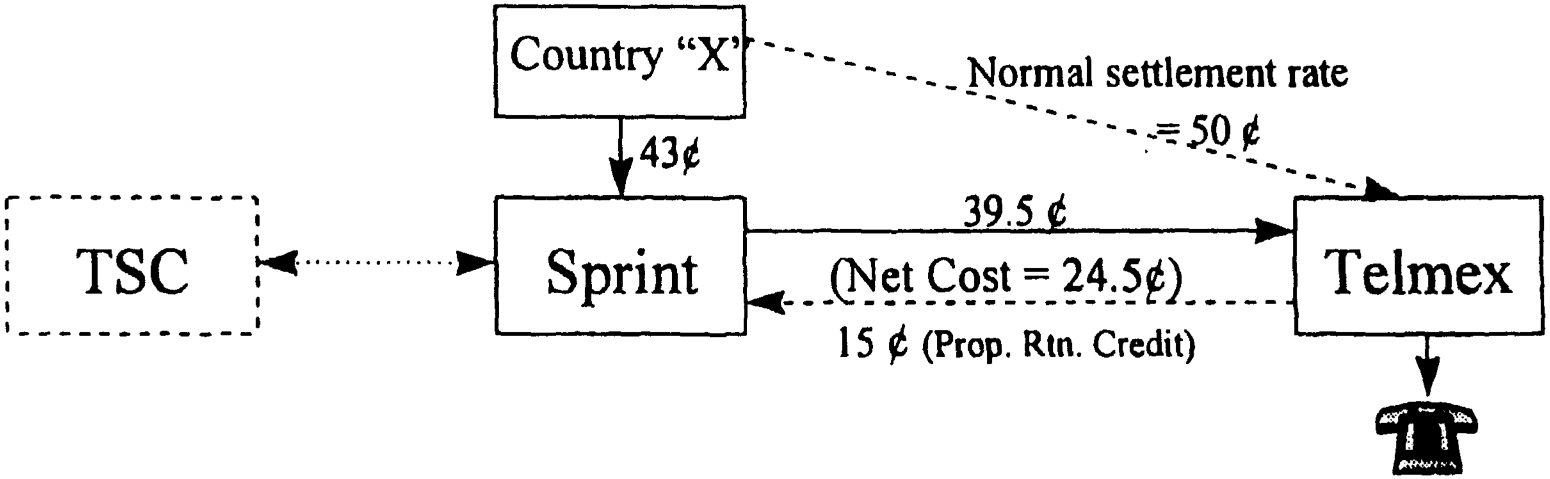
# Call Volume Enhancement




| | Before | After | Net Impact |
|---|---|---|---|
| Telmex | • 2,500M Southbound Minutes<br>• 1,000M Northbound Minutes<br>• $593M Net Settlements Revenue | • 2,700M Southbound Minutes<br>• 1000M Northbound Minutes<br>• $671M Net Settlements Revenue<br>• $64M Paid to TSC to Cover Costs | Gain of $14M |
| Sprint | • 275M Southbound Minutes<br>• 110M Northbound Minutes<br>• $65M Net Settlements Outpayment | • 475M Southbound Minutes<br>• 176M Northbound Minutes<br>• $118M Net Settlements Outpayment<br>• $60M International Wholesale Revenue | Gain of $7M |
| TSC | • N/A | • 200M Generated Minutes<br>• $60M International Wholesale Cost<br>• $64M Reimbursement from Telmex | Gain of $4M |
| Other U.S. Carriers | • 2,225M Southbound Minutes<br>• 890M Northbound Minutes<br>• $528M Net Settlements Outpayment | • 2,225M Southbound Minutes<br>• 824M Northbound Minutes<br>• $553M Net Settlements Outpayment | Loss of $25M |

- TSC artifically generates 200M S/B minutes
- TSC pays Sprint 30¢ per minute; TSC reimbursed 32¢ per minute by Telmex
- Sprint receivesa net addition of 66M N/B minutes due to "market share" growth
- Telmex gains 7¢ per new S/B minute

# Affiliate Reorigination




| | Before | After | Net Impact |
|---|---|---|---|
| Telmex | • 2,500M Southbound Minutes<br>• 1,000M Northbound Minutes<br>• $593M Net Settlements Revenue | • 2,600M Southbound Minutes<br>• 1000M Northbound Minutes<br>• $632M Net Settlements Revenue<br>• $50M Loss of 3rd Country Settlements<br>• $14M Covering Payment from Sprint | Gain of $3M |
| Sprint | • 275M Southbound Minutes<br>• 110M Northbound Minutes<br>• $65M Net Settlements Outpayment | • 375M Southbound Minutes<br>• 144M Northbound Minutes<br>• $91M Net Settlements Outpayment<br>• $14M Covering Payment to Telmex<br>• $43M Reorigination Revenue | Gain of $3M |
| Country "X" | • $50M Net Settlement to Telmex | • 43M Reorigination Payment to Sprint | Gain of $7M |
| Other U.S. Carriers | • 2,225M Southbound Minutes<br>• 890M Northbound Minutes<br>• $528M Net Settlements Outpayment | • 2,225M Southbound Minutes<br>• 856M Northbound Minutes<br>• $541M Net Settlements Outpayment | Loss of $13M |

- Sprint "reoriginates" 100M minutes of Country "X"-Mexico traffic through US at a price to "X" of 43¢/minute
- Telmex loses 11¢/minute (50¢ - 39.5¢); requires compensation from Sprint
- 43¢ price covers Sprint net costs of 24.5¢/minute plus 14¢/minute compensation to Telmex
- Sprint gains 34M N/B minutes due to "market share" growth