Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in South Carolina	CC Docket No. 97-208

To: The Commission

REPLY BRIEF IN SUPPORT OF APPLICATION BY BELLSOUTH CORPORATION, BELLSOUTH TELECOMMUNICATIONS, INC., AND BELLSOUTH LONG DISTANCE, INC. FOR PROVISION OF IN-REGION, INTERLATA SERVICES IN SOUTH CAROLINA

APPENDIX

BELLSOUTH
SOUTH CAROLINA § 271 REPLY

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In the Matter of
Application by BellSouth Corporation
for Provision of In-Region, InterLATA
Services

CC Docket No. 97-208

AFFIDAVIT OF GUY L. COCHRAN, being duly sworn, deposes and says:

1. My name is Guy L. Cochran. I filed an affidavit as part of the original filing in this docket before the Commission. The purpose of my affidavit is to reply to comments filed related to my original affidavit in this proceeding.

I. BELLSOUTH HAS ELECTED TO DISCLOSE ALL TRANSACTIONS ALTHOUGH BELLSOUTH HAS NO SECTION 272 SUBSIDIARY AT THIS TIME

2. AT&T and MCI believe that BellSouth has not complied with the public disclosure requirements of Section 272(b)(5). BellSouth could not possibly have violated these public disclosure requirements, as BellSouth currently does not provide services to which Section 272 applies, see Section 272(a)(2). BellSouth has, however, provided written disclosure of all transactions between BST and BellSouth Long Distance (BSLD).
3. This written disclosure provides information on compliance with the rules that applied at the time the transactions took place, namely the Commission's Affiliate Transaction Rules. For example, transactions performed during 1996 were on the fully distributed cost basis as required by the Rules. Clearly these are the only Rules which apply to these transactions.
4. In fact, if the Section 272 requirements were applicable as AT&T and MCI assert, BST would be able to apply the exception in the revised Affiliate

Transaction Rules released in CC Docket No. 96-150 to its transactions with BSLD. If Section 272 requirements were applicable, the more burdensome aspects of the revised rules, which BellSouth has applied to these transactions, would not be applicable. If Section 272 requirements were applicable, the fully distributed cost of each transaction would be irrelevant and would not have been the price of these transactions as indicated by BellSouth disclosure.

5. The written disclosure also describes those services which BST will provide to BellSouth Long Distance and is willing to provide to nonaffiliates on a nondiscriminatory basis after BellSouth receives 271 approval. My first affidavit in this proceeding at paragraph 24 clearly states that these services will be "nondiscriminatory". If such services are provided to BSLD, nonaffiliates would also be able to receive these services from BST under contract with the same terms, conditions, and rates as BSLD. In cases where BST has finalized its business decisions on the terms and conditions under which these services will be offered, and contracts have been negotiated with BSLD, these transactions are posted on BSLD's Internet page. Only after terms and conditions are final, will contracts be available for review at BST's Atlanta Headquarters and posted by BSLD on the Internet.

II. BELLSOUTH HAS CONTROLS IN PLACE

6. AT&T claims that BellSouth has no controls in place for Section 272 compliance, while Vanguard Cellular Systems, Inc. complains that BellSouth is not currently complying with Section 272. These claims are incorrect. First, BellSouth will continue to have safeguards in place to ensure compliance with all Commission rules. Second, as Section 271 approval has yet to be obtained, Section 272 compliance is not yet applicable.

7. Both the Cochran and Jarvis affidavits disclose that BSLD has been organized from its outset to allow compliance with Section 272 rules, although BSLD is not a Section 272 affiliate. Both affidavits discuss how BellSouth will comply with Section 272(b)(1-5). Specifically, BST and BSLD have (1) separate

employees, officers, and directors; (2) no joint ownership of switching or transmission equipment; (3) separate books of accounts; (4) accounting rules under which each entity's books are maintained; and (5) the annual reporting mechanisms and audits those reports are subject to.

8. The Cochran affidavit at paragraphs 20 and 22 also emphasizes that transactions between BSLD and BST are performed in accordance with the applicable Parts 64.902 and 32.27 Rules. Accordingly, as with all new nonregulated services or affiliate transactions, subject matter experts from legal, regulatory, and accounting participate on the product or transaction teams to educate teams on all applicable rules and laws.

III. FURTHER INFORMATION ON SPECIFIC TRANSACTIONS

9. The Telecommunications Resellers Association asserts that BellSouth does not intend to confine itself to the parameters of acceptable joint marketing activities as set forth in Section 251. This assertion is incorrect. The Telecommunications Act of 1996, effective February 8, 1996, allows the BOC to participate in joint marketing with its Section 272 affiliate. BellSouth has structured all joint marketing activity, including planning, in accordance with the guidelines and rules applicable at the time of the activity. In particular, in its Non-Accounting Safeguards Order the Commission concluded that a Bell company can meet its equal access obligations, while also engaging in joint marketing by informing the local exchange customers of their right to select the interLATA carrier of their choice and taking the customer's order for the interLATA carrier the customer selects.

10. MCI asserts that there are compliance issues related to the transactions described in the Jarvis affidavit at paragraph 14. MCI's assertion is incorrect. These descriptions provide information as to the affiliate transaction rule compliance (tariff, prevailing market price, or fully distributed cost) and the amount billed under that affiliate transaction rule. In addition to the descriptions included in Mr. Jarvis's affidavit, MCI has BellSouth's

transaction summaries that clearly state that Interoffice Testing - CO Switch is provided to affiliates based on BST's prevailing price. BST cannot record transactions at prevailing price unless sales to unaffiliated entities exist. Accordingly, End-to- End Testing is provided under standard tariffs. As indicated in the transaction summary provided to MCI, the End-to-End Testing performed for BSLD was the testing of electronic and manual interfaces between BST, BSLD, and AT&T. As MCI and other interexchange carriers are aware, due to their requests for the same type of service in the past, when BST provides customization of billing & collection services, BST charges that carrier cost for that work. Customization includes both planning and software services. The difference now for the customization work on Billing & Collection is that previously a carrier such as AT&T or MCI would be the only recipient of their customized process. However, in compliance with the nondiscrimination rules, the process which will be provided to BSLD will be provided to all carriers requesting this same service. Hence, as with other carriers the initial cost of customization was paid by BSLD, but as the actual service is performed for any carrier which requests this specific Billing & Collection process, BST will provide this services at set terms and conditions.

11. MCI goes on to suggest that BST has improperly granted BSLD collocation rights. MCI asserts that because BSLD has no long distance authority and its equipment is not yet operational, BST should not grant BSLD collocation. MCI is wrong. First, BellSouth does not require that carriers be operational at the time they obtain collocation space. The procedure used to allow BSLD collocation rights is no different than the procedure that would be used to allow any other carrier such rights. BSLD has signed BST's standard Collocation agreement. Furthermore, BST has shown no preferential treatment to BSLD with regard to amount of space, prices charged, or installation intervals.

12. MCI asserts that BST has allowed BSLD to use the "BellSouth" brand name without compensation to BST. MCI makes assumptions as to the ownership of the "BellSouth" brand name that are absolutely false. There is no agreement to be made between BST and BSLD concerning the "BellSouth" brand name. The "BellSouth" brand name belongs to BellSouth Corporation. BellSouth Corporation owns the brand name and allows its corporate family to use its brand name. The Commission has decided that BSLD does not have to compensate BST for the use of the Corporation's brand name.

13. MCI asserts that it is unable to conclude if "competitively sensitive information about BST services" was transferred to BSLD in the form of personal knowledge with the employees who were transferred from BST to BSLD. The Telecommunication Act of 1996 requires separate officers, directors, and employees. It does not prohibit the transfer of employees within BellSouth Corporation. There is nothing in the Act that prevents a BSLD employee from applying his or her knowledge and experience to work done for BSLD. Nevertheless, all BellSouth employees are required to sign personal responsibility commitments which include statements whereby employees are instructed not to misuse information gained while they are employed by BST or any other BellSouth entity. Specifically, the Personal Responsibility Handbook states as follows: "Proprietary information about customers, suppliers or partners shouldn't be used for inappropriate purposes by the BellSouth company that received the information. Nor should the information be inappropriately provided to other companies."

14. MCI asserts that there are improprieties associated with BST being reimbursed by BSLD for the 2 to 4 weeks it took to handle the payroll transition in early 1996. As the original Jarvis affidavit described, this transaction was for employee expense corrections. As the first employees from BST accepted positions at BSLD, the transition between payrolls was being worked out. BST continued to incur payroll and benefit costs for a period between two weeks and one month after the employees accepted

positions at BSLD. BellSouth Corporation's subsidiaries do not *drop* employees from the their payroll when the employee is transferring within BellSouth Corporation until medical coverage, tax withdrawals, etc. are transferred properly to the new BellSouth entity. As indicated by the Jarvis affidavit, prior to the implementation of CC Docket No. 96-150, transfer transactions were billed under the CC Docket No. 86-111 method of fully distributed cost so BSLD gained no advantage. As MCI could see from the disclosure of the transaction summaries it received from BST, fully distributed cost includes not only the direct costs related to the individual employees, but all overhead and the prescribed rate of return on investment as set by the Commission. This situation is not mirrored when an employee leaves the BellSouth family as items such as medical coverage and payroll taxes are no longer BellSouth's responsibility.

This concludes my affidavit

Guy L. Cochran

GUY L. COCHRAN

Subscribed and sworn before me on this 13th day of November, 1997

Janice E Padgett

NOTARY PUBLIC

Notary Public, Gwinnett County, GA
My Commission Expires Feb. 19, 2000

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Reply Declaration of Professor Jerry A. Hausman

1. I am MacDonald Professor of Economics at the Massachusetts Institute of Technology in Cambridge, Massachusetts, 02139. I submitted a previous declaration in this proceeding dated September 26, 1997.

2. In this reply declaration, I first respond to the economists for the IXCs who defend continuing the supra-competitive prices in residential long distance markets by maintaining the prohibition on BOC entry into long distance markets. The arguments of economists for the IXCs have changed little over the past 10 years, and meanwhile residential consumers have paid ten of billions of dollars in overcharges to the IXCs. Despite Congress' explicit intention to increase competition in telecommunications markets, these economists use their same old arguments in an attempt to permanently keep the BOCs from competing with their clients (e.g. Hall for MCI) or ask the Commission to engage in regulatory extortion (e.g. Shapiro for Sprint) until their client IXCs achieve their goals, many of which the Eighth Circuit has rejected as being inconsistent with the Telecommunications Act of 1996. I find it to be quite lamentable that the Commission is once again being urged to maintain policies which are costing consumers billions of dollar per year, do not make economic sense, and are contrary to the Telecommunication Act.[1] Instead, the Commission should be engaged in an economic analysis to determine if consumers would be made better off if BOCs are permitted to offer long distance, consistent with the public interest standard as I discussed in my first declaration.

3. I also reply to Prof. Marius Schwartz on behalf of the DOJ, who has

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1. See Jerry Hausman, "Valuing the Effect of Regulation on New Services in Telecommunications", forthcoming in Brookings Papers: Microeconomics 1997. I estimate that the Commission's actions with respect to refusing to allow the BOCs to provide voice mail cost consumers more than $10 billion and that the Commission's delay in approving cellular service cost consumers over $100 billion.

not changed his position from his first affidavit (May 1997). Prof. Schwartz has no economic model analyzing the costs and benefits of delaying BOC entry. Nor does he quantify the effects. Indeed, Prof. Schwartz makes some elementary mistakes. Thus, Prof. Schwartz does not do the fundamental economic analysis that would allow him to draw a reasoned conclusion about whether further delaying BOC entry to meet the "regulatory perfection" standard that I discussed in my first declaration meets the public interest standard set out in Section 271 of the Telecommunications Act of 1996.

I. Prof. Baumol (AT&T)

4. Prof. Baumol set as his standard that the BOCs should not be allowed to enter the long distance market until "concerns about anticompetitive conduct (concerns underlying the original imposition of the MFJ restrictions) have evaporated." I believe that Prof. Baumol has set the incorrect standard, and that his standard will harm consumers. Prof. Baumol pays no attention to developments in the U.S. where LECs with bottlenecks (according to Prof. Baumol) have been allowed to enter long distance markets and have brought down consumer prices, e.g. SNET. Nor does he provide an explanation of why long distance competition has worked in most developed countries, e.g. Canada, all of which allow incumbent LECs to provide long distance. Prof. Baumol has ignored this actual empirical experience and has written an essay justifying the line of business restrictions of the MFJ. Congress has since rejected the approach of the MFJ as has every other country that has considered the question.

5. Prof. Baumol's analysis would lead to a conclusion that vertical integration should not be permitted in the U.S. economy if the upstream firm has market power. Thus, his analysis would forbid Microsoft to supply word processors and spread sheet programs and would forbid Intel from supplying computers (integrated chips and boards which are the essential component of a computer). Yet economists have recognized repeatedly that vertical

integration typically leads to lower prices to consumers.[2] That is not to deny that competitors of Microsoft and Intel constantly attempt to cause the antitrust regulatory authorities to forbid Microsoft and Intel from competing in downstream markets. Yet no antitrust decision has ever stated that vertical integration should not be permitted, solely on the basis that in the upstream market the firm has substantial market power.

6. Only if the firm leverages its market power to cause higher prices in the downstream market are consumers injured.[3] Here, downstream prices will be lower for reasons I discussed in my original declaration, paras. 12-14, and the actual experience of SNET and GTE charging lower prices confirms the economic theory. Prof. Baumol seems not to have examined the real world experience of consumer benefits from LEC provision of long distance service in the last decade and a half. Economic learning did not stop with the signing of the MFJ in 1982.

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2. See the reference in fn. 5 of my first declaration what discuss vertical integration and the "double marginalization" problem which conclude that vertical integration will lead to lower prices to consumers. Prof. Baumol never discusses this well known analysis in his declaration.

3. Prof. Baumol does consider the "one monopoly" claim that all monopoly profits can be gained in the upstream market. Of course, this claim does not make economic sense in the current situation since long distance access prices are regulated. He claims that the BOCs will have an incentive to discriminate in providing access (the MFJ rationale), but after 10 years of equal access regulation experience, the chance that problems will arise is extremely small. Professor Marius Schwartz in his first affidavit for the DOJ (para. 74) concluded that no competitive problems are likely to exist from BOC entry into long distance, and that consumers would benefit from the increased competition, at least in the short run. (paras. 138-139)

II. <u>Dr. Baseman and Dr. Warren-Boulton (MCI)</u>

7. Dr. Baseman and Dr. Warren-Boulton (BWB) also use the MFJ standard of "effective competition in the markets for unbundled network elements and for retail local exchange services" (pp. 7-8) as their standard for permitting BOC entry into long distance. This standard is inconsistent with the Telecommunications Act of 1996. BWB recite the standard litany for why regulation cannot stop anti-competitive actions. However, again they completely fail to look at actual empirical experience. No IXC, even MCI, has even attempted to show that SNET or GTE has engaged in discrimination or cross-subsidy. Yet SNET has brought 17% lower prices to consumers and gained 35-40% of the long distance market in Connecticut. BWB simply recite reasons why BOCs will discriminate against MCI which have been made repeatedly with no empirical support, and which I expect to continue unless GTE acquires MCI.

8. BWB also discuss the "carrot" rationale for linking a BOC's entry into interLATA market with local competition. However, BWB do not do a public interest determination over whether consumers would be better off by BOC entry, as I did in my first declaration. Instead, they merely assume away any benefit from BOC entry. Of course, it is the IXCs' economic interest to keep the "carrot" permanently out of reach because SNET's entry and the experience in Canada and other countries have demonstrated that LECs will gain a substantial share of long distance markets when they enter. But what is "good for MCI is not necessarily good for consumers". Without any analysis of the net effect on consumers, the carrot approach is an excuse for maintaining barriers to BOC entry into long distance, thereby harming consumers.

9. In attempting to dismiss the effectiveness of regulation, BWB claim that the BOCs' entry into the long distance market would require detailed regulation. (p. 15) They seem unaware that the Commission has <u>already</u> decided that the BOCs will be treated as non-dominant interexchange carriers so that

detailed regulation is not necessary.[4] Thus, BWB's discussion of regulation has already been largely rejected by the Commission.

10. BWB next consider long distance access pricing. BWB attempt to re-argue the recent Commission decision on long distance access prices. Indeed, BWB attempt to set a standard that access prices must be reduced before the BOCs are allowed to enter (p. 24). BWB are basically arguing here that a BOC has an "unfair advantage" over an IXC because of the access regulation. However, again they never turn to the issue of whether, given the form of access regulation, BOCs have an incentive to offer lower long distance prices to consumers. They do have this incentive as I discussed in my first declaration, and empirical evidence in Connecticut proves that the theory holds.

11. BWB also fail to note that even if access were set at "economic cost", BOCs would still have an economic incentive (although reduced) to offer lower long distance prices to consumers. Vertical integration creates these incentives which lead to consumer benefit; BWB advance no economic analysis which disputes this fundamental point. Similarly, in considering the consumer benefits from one-stop shopping, BWB again state that the BOCs will have "major advantages in competing for customers who prefer to purchase a bundle of services." (p. 52) BWB are incorrect in this claim because IXCs also have the ability to bundle services as soon as Section 271 relief is granted which can be done immediately through resale. BWB are against making consumers better off if MCI faces a disadvantage from its competitors. But competition works when different firms can make use of their competitive advantages to offer preferred products and services to consumers. Consumer should not be

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4. It is my understanding that the Commission has previously decided to treat BOC providers of long distance as non-dominant. See Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, Regulatory Treatment of LEC Provision of Interexchange Services <u>Originating in the LEC's Local Exchange Area and Policy and rules Concerning</u> the Interstate, Interexchange Marketplace, FCC 97-142 (Apr. 18, 1997)

harmed by having to wait for BOC entry into long distance until MCI is convinced that all the BOCs' advantages no longer exist.

III. Prof. Shapiro (Sprint)

12. Prof. Shapiro attempts to establish a framework to evaluate the public interest standard and then applies it to the "current state of local exchange interconnection and local exchange competition in South Carolina". (p. 2). Prof. Shapiro makes absolutely no mention or analysis of benefits from increased long distance competition from BOC entry. He assumes that consumer benefits from local competition will be high (with no supporting evidence); but he fails to assess how effective regulation has been in keeping local exchange services at (or below) their economic cost. Thus, Prof. Shapiro assumes large benefits arising from local exchange competition, and he ignores benefits to consumers from lower long distance prices.[5] His framework fails to do the appropriate benefit-cost analysis of balancing the effects on consumer welfare from local competition and from long distance competition. This one-sided approach is inconsistent with a valid public interest analysis.

13. Prof. Shapiro does recognize that consumers would benefit from being offered bundled services. (pp. 9-10) However, he argues that "parity in the ability to bundle services" should be attained first. The ability to bundle is granted to IXCs once Section 271 entry is granted to the BOCs. IXCs can bundle through resale. Thus, Prof. Shapiro does not advance a valid reason to delay BOC entry. Again he is arguing that a firm should not be allowed to use its competitive advantages to make consumers better off. Prof. Shapiro's "bundling parity" standard (p. 10) demonstrates how consumers are

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5. Prof. Shapiro argues on a priori grounds that "adding another competitor" to the long distance market will bring little benefit. (p. 8) However, prof. Shapiro fails to consider the empirical evidence of SNET and GTE charging significantly lower prices. His mistake here is his failure to realize that a BOC is not just another competitor; a BOC is a particularly able competitor that has an economic incentive to charge lower prices because of its vertical integration.

harmed by regulatory protection of competitors such as Sprint. Prof. Shapiro should have concluded that in the absence of "bundling parity" Sprint would be required to lower its prices (as it has done in Canada) which would make consumers better off.[6] The CRTC (the Canadian regulatory authority) has not found it necessary to protect Sprint in Canada, and consumers have benefitted from lower prices. The public interest standard should be designed to help consumers, not to protect Sprint from competition.

IV. Profs. Hubbard and Lehr (AT&T)

14. The primary conclusion of Profs. Hubbard and Lehr (HL) is that long distance markets are "effectively competitive today." (p. 7) HL further conclude that BellSouth's entry into long distance markets will not increase competition, but instead it would threaten competition in long distance markets. (p. 8) Lastly, they state that BellSouth's ability to succeed in long distance competition is "not the relevant question." (p. 10) I reply to these contentions of HL.

15. HL consider various structural factors of long distance market such as the number of competitors and AT&T's market share. They also look at the decline in real (inflation adjusted) prices, a fact which is uncontested in this proceeding.[7] But, HL do no price (rate) comparisons for actual

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6. I discuss Sprint's lower prices in Canada in my first declaration, para. 27.

7. HL do an incorrect comparison in Figure 3 when they consider the real price of long distance. They include all switched long distance service which includes large businesses, small businesses, and residential consumers. Business have received lower prices, while residential customers have not benefitted nearly as much. Indeed, in Figure 4 real consumer prices fell by only 24% of which about 17.9% is the effect of inflation. Thus, nominal prices fell by only a little over 1% a year during this period. Furthermore, since nominal access prices decreased by 20.8%, or 4.6% per year, over this same period and AT&T has claimed repeatedly that access costs are 40-50% of its overall costs, decreases in access rates explain more than 100% of the decrease in residential long distance prices, using HL's AT&T data. (HL in Figure 7 compute that access is about 37% of AT&T long distance revenue and access is a significantly higher proportion of economic cost, given the large

customers, such as I did for SNET in Connecticut. If they had done so, they would have found that SNET's prices are lower.

16. Given that SNET offers lower prices, the conclusion should be that residential long distance prices are not effectively competitive. Otherwise, how can the two large LECs who are allowed to offer long distance offer significantly lower prices? HL also do not compare US long distance prices with Canadian long distance prices although I demonstrated that Canadian prices are lower. Indeed, HL never consider the main economic reason that LECs offer lower prices: the two margins factor that I discussed in my first declaration. HL's only response to Connecticut is to speculate that the price discounts may not be "long-term". (p. 63) Thus, they want to prevent customers from benefitting from the $6-7 billion per year that I computed because the benefit may not be "long-term"!

17. HL do not analyze SNET's prices and compare them to AT&T's prices because the outcome would be unfavorable. Furthermore, they neglect another important economic factor. HL refer to the importance of consumer sovereignty (p. 28), but fail to explain why consumers have given SNET a 35-40% share of long distance in Connecticut if long distance is vigorously competitive as they claim. (p. 29) Consumer choice demonstrates that when SNET has offered lower long distance prices, consumers have chosen SNET to the point where SNET is the second largest long distance provider in Connecticut. Given SNET's reported 41% growth rate in long distance, SNET may soon pass AT&T to become the largest long distance provider.

18. Similarly, after offering long distance for 18 months in its territories, GTE has also become the second largest long distance provider. Consumers vote with their dollars. A significant proportion of consumers have demonstrated that they prefer to buy long distance service from their LEC when

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margins in long distance.) Thus, AT&T's residential long distance prices increased once the effect of access prices are netted out, contrary to what HL claim for overall long distance prices.

lower prices are offered. Yet, HL find it to be in the "public interest" to refuse to let consumers vote with their dollars in a similar way in other states.

19. HL attempt to respond to my analysis that if regulation has been effective, expected gains from "regulatory perfection" are likely to be limited. Their only calculation which leads to a claimed savings of $15 billion per year (p. 64) is admittedly "back of the envelope" (fn. 80) and is absurdly wrong because the number of minutes it is based on is too small by a factor of at least 3-4 times. Residential customers make many more minutes of calls than HL incorrectly assume they make. HL never consider the cost of these local calls. HL "make up a number" to try to claim large benefits, but the number is wrong.

20. HL agree with me that the US is the only country not to allow LECs to provide long distance service. (pp. 66-67) They then say that the U.S. is unique with respect to its requirements of unbundling and resale. They are actually incorrect here since both Australia and Canada have similar regulations, although the details differ. However, HL miss my main point. Long distance prices are lower in Canada than the U.S. HL did not dispute my economic analysis here; they just ignore the fact. HL do not discuss why U.S. consumers benefit from paying higher long distance prices than their Canadian neighbors.

V. Prof. Hall (MCI)

21. Prof. Hall discusses vertical integration, but he fails to recognize the efficiency effects of vertical integration which have long been known to economists. Using Prof. Hall's approach neither Intel nor Microsoft would be allowed to vertically integrate, but the antitrust laws have never attempted to stop vertical integration. Indeed, most economists agree that large benefits to consumers have arisen from Intel's and Microsoft's vertical integration. Prof. Hall never discusses the international experience where

every other country except the U.S. has allowed vertical integration of its LEC. The outcome has been considerably more local competition in countries like the U.K. (cable companies providing about 7% of local residential service), and Australia (Optus the second long distance company provides an HFC network to residential customers). Thus, other countries have permitted vertical integration and have more local competition for residential customers than does the U.S. Prof. Hall has no answer in either economic theory or market experience to this international experience.

22. Prof. Hall attempts to minimize the benefits of one-stop shopping.[8] (p. 23) But market experience including the experience in Connecticut demonstrates that consumers prefer one-stop shopping. Thus, Prof. Hall argues against consumer sovereignty, a principle accepted by almost all economists. Prof. Hall is, in essence, saying that he can ignore market outcomes because he cannot understand the source of the efficiencies. If consumers have demonstrated they prefer one-stop shopping they must be wrong accordingly to Prof. Hall.

23. Prof. Hall attempts to explain SNET's success in Connecticut with 35-40% of the long distance market by claiming that "SNET has a huge competitive advantage". (p. 28) He admits that SNET's prices are lower in Connecticut: "The national long-distance carriers would have to lower their prices nationally in order to respond to SNET's pricing".[9] Contrary to Prof. Hall, SNET's entry has led to lower prices for consumers. Prof. Hall's assertion is incorrect because he fails to consider SNET's one rate type plan when he considers analogous plans from AT&T and MCI. SNET's prices are lower and thus customers have benefitted from SNET's "huge competitive advantage".

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8. Interestingly, HL for AT&T admit to the consumer benefits from one stop shopping.

9. Note that this admission directly contradicts Prof. Hall's later assertion that AT&T offers lower long distance prices nationally than SNET does in Connecticut. (see Hall, p. 66)

Firms compete based on competitive advantages and customers benefit when the advantages are used to lower prices.

24. Prof. Hall agrees that the margin inherent in long distance access can lead to the result that "the local carrier may reduce the price of long-distance service".[10] (p. 30) But he states that this effect should not be considered as a benefit! Lower prices always benefit consumers (holding quality constant). Again Prof. Hall wants to deny benefits to consumers because he does not like how they arise, here through vertical integration. Furthermore, since he has no answer to consumers voting with their dollars to buy SNET's long distance service, he states that this large market share is "no indicator of social benefits". Here he is directly contradicted by economic theory which demonstrates that consumer benefits are directly proportional to the revenue from a "new brand" as I have demonstrated in my academic research.[11] Prof. Hall attempts to deny well accepted economic theory in his attempt to claim that BOC entry into long distance will not create consumer benefits.

25. Prof. Hall claims that the long distance market is competitive by considering the real price of long distance in his Figure 1 (p. 41). Here he has combined business and residential calls, so that the main effect of BOC entry, lower prices for residential customers, would not appear. Businesses may have a competitive long distance market; residential customers do not. Furthermore, as demonstrated by Prof. Hall's Figure 2, both the real CPI for long distance and real PPI for long distance services have been essentially

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10. Note that statement directly contradicts Prof. Hall's subsequent claim that double marginalization will not lead to lower long distance prices. (p. 64)

11. See J. Hausman, "Valuation of New Goods Under Perfect and Imperfect Competition", in T. Bresnahan and R. Gordon, The Economics of New Goods, Univ. Of Chicago Press, 1997; "Valuation and the Effect of Regulation on New Services in Telecommunications", forthcoming in Brookings Papers on Economic Activity: Microeconomics, 1997; and "The CPI Commission and New Goods", American Economic Review, 1997.

constant since 1991 (Prof. Hall does not provide the data so no exact calculations can be done). Prof. Hubbard and Lehr provide a more accurate compilation of long distance prices over the 1990-1995 period which shows that no decrease in residential nominal long distance prices exists. When Prof. Hall compares access charges to long distance revenues (p. 45), he again mixes business and residential revenues. Using data from Prof. Hubbard and Lehr, I demonstrated above that residential long distance prices have increased over the 1990-1995 net of access charges. Thus, Prof. Hall's use of combined business and residential data does nothing to demonstrate that residential long distance customers receive competitive prices.

26. Prof. Hall disagrees with my double marginalization analysis. (pp. 64-65) Prof. Hall misunderstands the argument--it is not that the downstream operation faces the upstream marginal cost since an opportunity cost exists of selling long distance access to the IXCs. However, when the profit maximization calculations are carried out (as they are done in many textbooks), the vertically integrated company has an economic incentive to lower price because its will gain additional profits from its own and its competitors use of increased long distance access.[12] The IXCs do not have this extra economic incentive.

27. Prof. Hall disagrees with my comparisons of SNET's prices to AT&T's prices and he comes to the remarkable and incorrect conclusion that SNET is not cheaper than AT&T (p. 66). Prof. Hall's conclusion is remarkable because he has no explanation for why SNET has a 35-40% market share in long distance and is growing at 40% per year. (Hausman, para. 16) Have this many consumers made the wrong choice? Prof. Hall is also incorrect because his comparison standard is a 10 cent rate from AT&T. Here Prof. Hall is wrong for two

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12. Prof. Hall claims that this incentive arises from above cost access prices. He is wrong. So long as access prices reflect the significant sunk costs of providing long distance access, the economic incentive remains for a LEC to offer lower long distance prices.

reasons: (1) he fails to state that the AT&T 10 cent plan requires a monthly payment of $4.95 per month. Thus, compared to the much more widely advertised AT&T plan of 15 cents per minute, which requires no monthly charge, a user would need to make 100 minutes of calls per month until he broke even.[13] For many users near this amount, they would need to make significantly greater use of the plan to compensate for months where they made fewer calls and fell below the break even limit. (2) Many AT&T customers make use of no plan. Indeed, the most recent data reported in the business press indicates that only about 1/2 of AT&T's customer use any type of discount plan.[14] These customers would all benefit by going to SNET, no matter what their level of calling, as I demonstrated in my first declaration.

28. Furthermore, SNET bills by the second and AT&T bills by the minute. When these features are accounted for as I discussed in my first declaration, a user would need to make over 150 minutes of long distance calls before breaking even on the AT&T plan. Indeed, it is remarkable that Prof. Hall's client MCI does not offer a competitive offering to the AT&T plan that Prof. Hall discusses, since MCI's least expensive one rate plan is 12 cents a minute for amounts beyond $15 per month.[15] If the AT&T plan were widely known and used as Prof. Hall implies, I find it extremely unlikely that MCI would not respond with a similar plan, but would only offer a higher priced plan. MCI's brand name is not so powerful that it could charge a higher price than AT&T. The economic facts of SNET's market gains and MCI's own pricing behavior are grossly inconsistent with Prof. Hall's claims.

29. Prof. Hall also errs in his criticism of my comparison to Canada.

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13. Prof. hall gives no source for his claim that the 10 cent rate is "widely advertised". The AT&T 15 cent rates is much more widely advertised, at least in my experience.

14. "AT&T Will Simplify Its Pricing Structure", <u>New York Times</u>, Nov. 5, 1997, p. D6.

15. The MCI plan is 15 cents per minute otherwise.