

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

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)
)
Petition for Expedited Declaratory Rulings) CC Docket No. 98-5

COMMENTS OF WORLDCOM, INC.

WorldCom, Inc. ("WorldCom"), by its undersigned counsel, hereby submits its comments on the "Fast Track' Plan to Expedite Residential Local Competition and Section 271 Entry Through Establishment of Independent RBOC Wholesale and Retail Service Companies," filed with the Commission by LCI International Telecom Corp. ("LCI") on January 22, 1998. *See Public Notice*, DA 98-130 (released Jan. 26, 1998).

As discussed below, LCI's Petition raises a critical issue, which is central to the development of telecommunications policy in the United States—that is, the fundamental conflict between the RBOCs' business interests and the public interest, as formulated in the Telecommunications Act of 1996 and this Commission's decisions implementing that Act, in promoting non-discriminatory competitive access to bottleneck local exchange facilities. The LCI Petition also presents a proposed solution to this issue in the form of a voluntary restructuring of RBOCs into wholesale and retail subsidiaries. WorldCom respectfully submits that the LCI proposal does not go far enough, and that the Commission should investigate a more thorough restructuring of the RBOCs, including full divestiture of bottleneck facilities, in cooperation with state regulators.

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Although WorldCom does not agree with all of LCI's proposals, WorldCom does largely agree with LCI's analysis of the problems with the *status quo*, especially pages 5-12 of its Petition. In particular, LCI has correctly identified the recurring antitrust problem that led to the divestiture of the old Bell System, and that currently prevents broad-based competition for local telephone service: Unless incited otherwise, an integrated telephone company's network operations and provisioning will favor its own retail sales, marketing, and customer service over "wholesale" customers who compete with the company in downstream markets. This problem existed in the 1970s when the downstream market was long distance service, and it exists today when the downstream market is local telephone service. It becomes an antitrust concern when the incumbent company controls bottleneck facilities, and discriminates in the quality of access to those facilities in order to protect its position in the retail market.

MFS Communications, which subsequently merged into WorldCom, identified this problem in late 1996 and offered a proposal to the Department of Justice that was in many ways strikingly similar to LCI's "Fast Track" plan. (A copy of MFS' 1996 submission is attached hereto as Exhibit A.) Both the MFS and LCI plans propose that a BOC's application for interLATA entry should be expedited, and presumed to be in compliance with the Section 271 checklist, if the BOC has voluntarily restructured its operations to separate bottleneck network facilities from its retail sales. The proposals differ, however, in two key respects. First, MFS suggested that a "Loop Entity" controlling only the BOC's local loop facilities, main distribution frames, central office buildings and power plants, and associated operations support systems be separated from a "Retail/Switching Entity" controlling the rest of the BOC's network facilities and services. LCI, by contrast, proposes a separation between a "NetCo" controlling *all* of the BOC's network facilities, and a "ServeCo"

providing only retail services as a pure reseller. Second, MFS proposed that the Loop Entity have completely separate ownership from the Retail/Switching Entity, but LCI's plan would allow the BOC to retain full ownership of NetCo as well as up to 60% of ServeCo.

For present purposes, the similarities between MFS' 1996 proposal and LCI's 1998 filing are more important than the differences. Regardless of whether the bottleneck in the BOC network is limited to the loop facilities, or is defined more broadly to include switches and other elements of the network, it remains true that the BOC does control bottleneck facilities; that downstream (retail) service providers cannot deploy widespread service on an economically viable basis without access to those facilities; and that as long as the BOC is competing with those downstream providers it will have an irresistible incentive to favor its own retail operations in network provisioning, maintenance, and pricing.

Only full and complete ownership separation between the bottleneck facilities and the retail operations will suffice to eliminate this incentive. It is simple common sense that responsible business managers will try to advance the interests of their company, not the interests of its competitors. The Telecommunications Act of 1996 sought to influence the BOCs' behavior by offering them interLATA entry in exchange for compliance with the competitive checklist. These provisions were based on the belief that BOC managers would take steps to promote local competition if they perceived these actions as advancing the interest of their company in entering the interLATA market. Experience over the last two years, however, has demonstrated that the "carrot" of interLATA entry simply is not enough to tilt the balance of BOC behavior. BOC managers evidently still believe their companies' interest in protecting their retail operations against competitive entry outweighs their interest in interLATA relief. Of course, they would like to have

both, and make that extremely clear in their public statements and lobbying, but their everyday actions demonstrate which of the two is more important to them.

LCI's Petition documents many of the major anticompetitive acts resulting from the BOCs' incentive to favor their own retail operations. These include grossly inadequate and discriminatory OSS interfaces; unreasonable restrictions on access to and combining of unbundled network elements; and excessive prices including outrageous non-recurring charges for network elements. It could well have added many other issues chronicled in the various Commission decisions rejecting BOC petitions under Section 271, including refusals to allow resale of contract service arrangements; evasion and outright violations of the Section 272 structural separation requirements; and provision of second-rate installation and maintenance services to CLEC customers.

In principle, any one or more of these issues could be addressed by this Commission and the states using their enforcement powers under Sections 251 and 252 of the Communications Act; and, certainly, more vigorous action along these lines would be welcomed by WorldCom. In the long run, however, it is evident that the regulatory process is an endless treadmill. Every time one issue is resolved, two or three more have popped up to take its place. The BOCs' ability to find ways to discriminate against and disadvantage their rivals is effectively infinite, while competitors' resources and the regulators' enforcement capabilities are necessarily finite. Traditional regulatory enforcement can only treat the symptoms of the bottleneck disease, not perform a cure.

The only way the goals of Section 251 can be achieved is if the BOCs have a real interest in achieving them. This will not happen as long as the Bell Operating Company both controls bottleneck facilities and markets competitive services that are based on access to those facilities. Voluntary divestiture works—it solved a similar problem in the long distance industry 15 years ago,

and it can solve the problem in the local industry today. It works because, after divestiture, the company controlling the bottleneck facilities has no business reason to favor one user of its network over another.

The RBOCs are likely to respond to the LCI Petition by pointing out that neither Congress nor this Commission (to date) has adopted divestiture as a *requirement* to be fulfilled before a BOC can enter the long-distance market. This is true enough, but beside the point. The Commission should ask the BOCs to explain why *voluntary* divestiture should not be encouraged through the use of “fast-track” procedures as proposed by LCI and previously by MFS, and perhaps by the creation of other regulatory incentives. Absent any advantages resulting purely from anticompetitive exploitation of the bottleneck, it is difficult to see why the BOCs would oppose restructuring. On the other hand, if the only benefits to the BOCs in remaining as integrated companies are those derived from anticompetitive incentives, then public policy should strongly promote divestiture.

Assuming that the BOCs will not, at least initially, respond enthusiastically to suggestions of divestiture, the Commission should proceed to investigate more fully both the advantages of divestiture (as opposed to LCI’s partial-separation approach), and the creation of appropriate incentives that would encourage the BOCs to pursue reorganization as a means of expediting interLATA relief (and perhaps achieving other of their regulatory goals). As part of this investigation, the Commission should assess the relative merits of a wholesale/retail separation as proposed by LCI, and the loop/switching separation proposed by MFS in 1996. The Commission may also wish to consider other options. For example, LCI refers at pages 35-36 of its Petition to several state commission decisions establishing “independent system operators” (ISOs) to operate electric utility transmission facilities, as an alternative to divestiture. Although LCI does not propose

the adoption of the ISO model in the telecommunications industry, the Commission may nevertheless wish to explore whether this model could be applied usefully as a means of resolving issues relating to the management and control of interconnection and unbundling of bottleneck elements.

In any investigation of BOC structural reform, WorldCom agrees with LCI that the state commissions must play a key role as well as this Commission. Any reorganization of the BOCs will affect the delivery of local exchange service, which is a traditional state concern. This Commission should encourage BOCs that really want Section 271 approval to work closely, and expeditiously, with their state regulators to develop solutions that include meaningful structural separation. Indeed, a number of state commissions are already investigating the issues raised by the LCI Petition. It has been reported that both the Illinois and Oklahoma regulatory commissions have initiated proceedings to consider the restructuring of BOCs, and the California and New York commissions are considering similar steps. *See* "LCI Seeks to Enroll States in its Campaign for Bell Wholesale-Retail Splits," 16 *State Telephone Regulation Report* No. 5, at 5-6 (Mar. 6, 1998).

WorldCom urges the Commission to cooperate with these state investigations, and to consider state-devised structural remedies in the Section 271 evaluation process, rather than attempting to impose a single nationwide model. Only by erecting a wall between the retail functions of the BOCs and the essential network facilities they control can regulators, at both the federal and state levels, be assured that BOC interLATA entry will be consistent with the public interest and that compliance with the competitive checklist will be real and substantive rather than skin-deep.

For the foregoing reasons, WorldCom urges the Commission to investigate the issues raised in the LCI Petition, and to work closely with state regulators in developing solutions. LCI is correct in concluding that the business interests of the RBOCs, as currently structured, are irreconcilable with the policy goal of Congress and this Commission to assure non-discriminatory competitive access to bottleneck facilities. As explained above, however, this investigation should not be limited to a simple "yes-or-no" consideration of LCI's specific proposal, but should include alternatives such as the 1996 MFS position paper, the "independent system operator" model used in the electric utility industry, and other alternative proposals. The objective of this investigation should be to devise a structural remedy that will eliminate the inherent conflict of interests between the interests of the BOCs' retail operations and the public interest in non-discriminatory access to essential network facilities.

Respectfully submitted,



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EXHIBIT A

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December 13, 1996

VIA COURIER

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

Dear Mr. Russell:

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

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

Sincerely,



Mark Sievers

cc: David Porter

EXHIBIT A

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

**DEPARTMENT OF JUSTICE
ANTITRUST DIVISION**

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

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

INTRODUCTION AND SUMMARY

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

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

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

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

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

- ▶ ***Reduce and maintain access charges (both long distance access and access to essential local network elements) at economic costs.*** This would reduce the ability of BOCs to leverage access charges to obtain a competitive advantage over long distance and local exchange rivals, but it is unclear when and to what extent access charges will be restructured. Likewise, while the Telecommunications Act requires cost-based charges for interconnection and unbundled elements, BOC prices for access to unbundled elements are far from the cost-based levels and the FCC's efforts to set the price of essential local network elements at economic cost has been stayed,^{2/} so it is unclear how effective regulators will ultimately be in this area. Also dramatic reductions in long distance access charges will reduce incentives for competitors to enter access markets and provide competitive alternatives to the BOCs' access services, so it is unclear whether, in the long run, this policy option advances or retards competition.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(continued...)

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

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

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

^{9/} (...continued)
telephone exchange service.” The Retail/Switching entity is clearly providing wireline telephone exchange service to the public for a fee. Similarly, the Local Loop entity would provide wireline telephone exchange service for a fee. Since it would sell loops primarily to telecommunications carriers, the only issue might be whether it will offer its services “to the public or such classes of users as to be effectively available to the public.” However, so long as the Local Loop entity is not prohibited from selling loops to the public it will satisfy the “to the public” portion of the test. There may be many instances where individuals or non-telecommunications carriers (e.g., Internet providers, banks, schools, alarm monitoring companies seeking to configure dedicated, high-speed connections with customers) might wish to purchase and use the loops provided by the Local Loop entity.

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

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

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

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

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

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

A. BOC Entry Threatens Competition in the Long Distance Market

BOCs enjoy an overwhelming competitive advantage over long distance carriers because BOCs supply access services, a long distance carrier's largest expense. It is widely recognized that long distance access charges are set substantially above the cost-based level one would expect to persist in a competitive market.^{7/} If BOC entry is allowed, BOCs will be able to drive long distance competitors out of the market by leveraging the subsidies embedded in access charges. The economic dynamics of the problem are illustrated by the tables that follow.^{8/} Table 1 is the Base Case. It illustrates a market where long distance firms sell services for 22¢ a minute. Their incremental costs for the services, a total of 13¢ a minute, consist of the access charges paid to the BOCs, assumed to be 7¢ a minute, and other costs assumed to be 6¢ per minute. Their common costs are assumed to be \$300 million or about 33% of total costs. The volumes of 10 billion minutes are simply assumed for the illustration.

^{7/} A survey of subsidy mechanisms in the telecommunications industry was prepared by the FCC Staff in Common Carrier Bureau, *Preparing for Addressing Universal Service Issues: A Review of Current Interstate Support Mechanisms*, pg. 26 (Feb. 23, 1996). A review of telecommunications subsidy studies is in C. Weinhaus, *et al.*, *Apples and Oranges: Differences between Various Subsidy Studies*, Telecommunications Industry Analysis Project (July 19, 1995).

^{8/} The numerical example is drawn from MFS Comments filed in In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended; and, Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area, CC Docket No. 96-149 (Aug. 15, 1996), Attachment 1.

Table 1 -- Base Case

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

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

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

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

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

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

Table 2 -- Strategic Repricing by Vertically Integrated BOC

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

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

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

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

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

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

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

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

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

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

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

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