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customers to CLEC accounts -- even though the implementation of such interfaces is required. Moreover, access charges are still significantly above cost and both federal and state universal reform is incomplete.²⁰

24. The failure to implement the pro-competitive provisions of the Act fully might be less worrisome if there were substantial evidence that local competition is progressing irrespective of the Act. Unfortunately and understandably, as we explain in the next section, local competition is emerging more slowly.

25. The cost to consumers of delaying the effective local competition are substantial. Contrary to arguments by the ILECs, local services are priced significantly above economic costs and the potential welfare gains from allowing increased competition to drive prices closer to costs may well exceed \$19 billion each year nationally.²¹ Allowing BellSouth

²⁰ In its access charge reform decision, the FCC declined to set access charges at a level corresponding to economic costs immediately, adopting instead a transitional approach that will move access to costs over a longer period (see *Second Report and Order, In the Matter of Access Charge Reform, Before the Federal Communications Commission, CC Docket No. 96-262, May 21, 1997* -- hereafter, referred to as the "FCC Access Charge order").

²¹ See R. Glenn Hubbard and William Lehr, *Improving Local Exchange Competition: Regulatory Crossroads*, note 13, *supra*. This estimate is conservative because it is based on an evaluation of the average revenue per residential line compared to the economic costs of providing services and because it ignores the stimulation in demand that will follow lower prices and the multiplier effect on the general economy of reductions in such basic infrastructure prices as telephone services. Moreover, it is commonly recognized that services to high value business customers are priced significantly above costs. Were the average revenue estimates adjusted to reflect the share of commercial traffic and the higher prices paid by these customers, the estimate of welfare benefits from allowing competition to move all prices closer to cost would be significantly larger.

to enter long distance at this time would threaten realization of these potential gains. A full accounting of the public interest must consider these costs.

III. STATE OF COMPETITION IN LONG DISTANCE AND LOCAL EXCHANGE MARKETS

26. In the following two subsections, we examine empirical evidence regarding the current effectiveness of competition in long distance and local exchange services. This analysis demonstrates that, by *every* empirical measure, long distance services are effectively competitive today, while local services remain a monopoly. Moreover, because local services (*e.g.*, local access) are an essential input to long distance services, the state of competition in local services has a direct effect on the costs -- and therefore prices -- of long distance services.

27. This empirical assessment of market structure and performance leads us to anticipate significantly larger gains for consumers from the success of local competition than from further entry into long distance services.²² Elementary economics teaches us that

²² This conclusion is shared by Professor Marius Schwartz in his recent response to the contrary arguments of BOC economic witnesses:

"[T]here is much more room to improve economic performance in the local market than in the interLATA market by fostering additional competition [E]ven a modest dose of increased competition in the local market can be expected to generate major benefits -- in the form of reduced costs, improved quality, increased variety of offerings, rationalization of the price structure in local markets, as well as spillover benefits in adjacent markets for interexchange and integrated services."

Supplemental Affidavit of Marius Schwartz on Behalf of the U.S. Department of Justice, In the

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competitive markets are generally efficient because prices approximate economic costs and firms are forced to adopt efficient, cost-minimizing technologies in order to survive. While additional entry into a competitive market demonstrates its health -- and the absence of entry barriers -- it is not expected to have a significant impact on either prices or costs (because costs and prices already approximate economic costs). In contrast, monopoly markets are typically not efficient. The monopolist is able to set prices above costs and offer consumers inferior quality goods or services. The monopolist is also unlikely to be minimizing costs.²³ Therefore introducing competition to a monopoly market such as local services is likely to result in significant efficiency gains and price declines.

A. Competition in Long Distance Markets

28. The market for long distance services demonstrates vigorous and effective competition.²⁴ Realization of this beneficial state has taken many years. Prior to 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, ¶ 18, CC Docket No. 97-208, November 4, 1997.

²³ While direct regulatory oversight helps mitigate these effects -- especially with respect to restraining the monopolist's ability to earn surplus profits by setting prices significantly above costs -- direct regulation is imperfect and inefficient.

²⁴ For further discussion of the state of long distance competition, see B. Douglas Bernheim and Robert D. Willig, *The Scope of Competition in Telecommunications*, AEI Studies in Telecommunications Regulation, Washington DC: American Enterprise Institute, 1998, forthcoming; David L. Kaserman and John W. Mayo, "Competition and Asymmetric Regulation in Long-Distance Telecommunications: An Assessment of the Evidence," *CommLaw Conspectus*, Vol. 4, Winter 1996, pages 1-26; Declaration of R. Glenn Hubbard and William H. Lehr, in *United States of America v. Western Electric Company and American Telephone and Telegraph*

divestiture of the Bell System in 1984, most consumers were served by a single, integrated provider of local and long distance services. For over a decade prior to this date, the technology had existed to facilitate competition in long distance services, yet the Bell System's dominance over local services and preferential access to essential interconnection and local access facilities severely hampered the development of long distance competition. Similar problems were faced by potential competitors in the markets for telecommunications network equipment and customer premises equipment.

29. The principal goal of the MFJ, which effected the divestiture of the Bell System, was the mitigation of the potential for anticompetitive practices by isolating monopoly "bottleneck" facilities from complementary competitive (or potentially competitive) services. Hence the MFJ required the divestiture of the local telephone companies, which held the bottleneck facilities (*e.g.*, such local network elements as switches, loops, and local transport facilities). The local telephone companies reorganized as the BOCs were proscribed, *inter alia*, from providing interLATA services.

30. The BOCs were required to enable the provision of equal access to allow consumers to select freely among alternative long distance providers and to interconnect with

Company, U.S.D.C., Civil Action No. 82-0192, November 1994; Ingo Vogelsang and Bridget M. Mitchell, *Telecommunications Competition: The Last Ten Miles*, Cambridge: MIT Press (for the American Enterprise Institute, 1997); Long Distance Market Shares Fourth Quarter 1996, FCC Common Carrier Bureau, Industry Analysis Division, released March 1997; *True Competition in the Long-Distance Market*, MCI Communications Corporation, white paper, January 27, 1997.

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those carriers over equivalent-quality connections. Equal access enabled "dial-1" access to carriers other than AT&T. While these new facilities were being deployed, the other common carriers (OCCs) were provided a discount relative to the local access fees paid by AT&T to compensate the OCCs' customers for the inferior quality access services they were provided.²⁵ The BOCs had a strong incentive to encourage increased competition in long distance services because this would stimulate demand for the BOCs' access services.

31. The FCC continued to regulate AT&T as a dominant carrier to assure that it did not use any residual market power to hinder the development of robust competition in long distance services. As we discuss more fully below, this process ended with the reclassification of AT&T as a non-dominant carrier in November 1995. Today, and for the past several years, we have had extensive competition among a diverse array of facilities-based and

²⁵ Successful implementation of the "equal access" provisions took several years. The share of access lines which were converted to support equal access varied as follows (see Federal Communications Commission, *Statistics of Communications Common Carriers, 1995/1996 Edition*, Table 8.8):

	% Equal Access
December 1984	3.1
December 1985	39.6
December 1986	63.3
December 1987	75.9
December 1988	83.0
December 1989	86.2
December 1995	98.9

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non-facilities-based national and regional long distance competitors, offering a diverse array of both wholesale and retail services.

32. There is ample empirical evidence of the extent of competition in long distance services and of the significant benefits realized by consumers as a consequence. *First*, the history and patterns of entry into this industry demonstrate the absence of significant entry barriers and the presence of diverse and widespread choices for consumers. *Second*, patterns and trends in market shares indicate that the competitive process is dynamically vigorous. *Third*, the broad and extensive declines in long distance prices provide a direct indication of consumer benefits. *Fourth*, the nature of competition as indicated by the marketing and advertising programs used by long distance carriers demonstrates the vibrancy and aggressiveness of competition and the frequency with which this competition is price-based. *Fifth*, the structure of the industry with competitive wholesale markets for bulk transport services guarantees that entry remains free and the long distance market is competitive. *Sixth*, the behavior of customers, as evidenced by the extent of customer churn, demonstrates that consumers understand that they have competitive choices and are asserting their sovereignty to freely choose among multiple carriers. *Seventh*, and finally, the financial performance of long distance carriers indicates that they are earning no more than a competitive return.²⁶

²⁶ See Declaration of R. Glenn Hubbard and William H. Lehr, note 24, *supra*.

1. Entry patterns demonstrate the absence of significant entry barriers.

33. Evidence of vigorous entry into (and exit from) an industry demonstrates the absence of significant entry barriers, which is a necessary precondition for effective competition.²⁷ Today, there are over 850 firms competing in markets for long distance services -- a number that increases with each year (see Exhibit 2).²⁸ This includes a diverse array of facilities-based and non-facilities-based and national and regional carriers.

34. The effectiveness and importance of resale competition (from non-facilities based carriers) is especially illustrative and interesting in light of the challenge of introducing competition in local exchange services.²⁹ Often the least-cost, most efficient entry strategy is to start as a reseller of wholesale services provided by facilities-based carriers, while investing in facilities as needs and opportunities dictate. This flexible entry strategy permits even relatively small firms to enter a capital-intensive industry incrementally. For example, both MCI and

²⁷ A 1996 study by Simran Kahai, David Kaserman, and John Mayo of the state of long distance competition rejected the hypothesis that AT&T possesses market power and estimated a supply elasticity for fringe firms of 4.38 -- suggesting a large supply response by smaller fringe firms to a price change. See Simran Kahai, David Kaserman, and John Mayo, "Is the 'Dominant Firm' Dominant?: An Empirical Analysis of AT&T's Market Power," *Journal of Law and Economics*, 39 (October 1996) pages 499-517.

²⁸ Another indicator of the ease of entry into long distance services is provided by the number of Carrier Identification Codes which are assigned. See Exhibit 3.

²⁹ As we explain further below, resale in long distance is more akin to the prospective market for UNEs than it is to Total Service Resale of local services. However, while we have significant market experience with long distance resale, firms have not yet implemented successful resale of UNEs. Removal of the regulatory barriers does not eliminate the economic barriers to entry nor demonstrate the commercial viability of resale of UNEs.

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Sprint relied heavily on resale of AT&T services (at nationally averaged rates) while they were constructing their networks, and new competitors such as Excel, Worldcom, and Frontier are using resale to support their growth. Access to resale reduces the costs of facilities-based entry; and increased facilities-based entry reduces the costs of resale. The process thereby feeds on itself, promoting competition at both the wholesale and retail levels.

2. Market share trends demonstrate continued decline in AT&T market share.

35. Based on traditional measures of concentration (based on revenue shares), the long distance market would appear to be concentrated with a little over 70 percent of industry revenues attributable to the top three carriers (AT&T, MCI, and Sprint). However, the market has in fact become increasingly *less* concentrated over time: AT&T's market share has fallen from more than 91 percent to 44 percent between 1984 and 1998.³⁰ Moreover, this trend has been continuous from 1984 to the present and most of the market share currently being lost by AT&T has been captured by smaller firms other than MCI and Sprint.

36. To put things in perspective, the growth experience of some of the newer competitors such as Excel, Worldcom, or Frontier compares quite favorably with either the MCI or Sprint of a decade ago, indicating that there is no shortage of candidates to offer

³⁰ See Table 3.5, FCC Common Carrier Bureau, *Long Distance Market Shares*, June, 1998.

robust facilities-based competition to today's big three.³¹ Such life-cycle comparisons are instructive because developing into a full-fledged facilities-based carrier takes time.

3. Price trends demonstrate real declines, net of access reductions.

37. Prices for long distance services have declined significantly since 1984, even after accounting for declines in access charges. Exhibit 4 shows that AT&T's Average Revenue Per Minute (ARPM) for switched interstate toll fell over 66 percent in real terms since divestiture -- and, net of access, prices declined by 44 percent. Moreover, these declines were experienced across service categories, and were even larger for some services. For example, Exhibit 5 shows that between 1990 and 1997, real prices for consumer dial direct, business outbound, and business inbound toll services declined between 23 and 51 percent, offering benefits to all types of consumers.³² Exhibit 6 demonstrates that all classes of

³¹ See *ibid.*

	Revenue Share of Toll Revenues		
	1984:1Q	1997:1Q	1998:1Q
AT&T	91.2%	49.1%	44.1%
MCI	5.0%	18.7%	19.0%
SPRINT	3.2%	9.3%	9.3%
WORLDCOM	n/a	5.6%	6.5%
OTHER	0.7%	17.4%	21.1%

WorldCom and other carriers captured an additional 4.6 percent over the past year alone.

³² For example, according to the trade press, prices to corporate business customers declined by 80 percent (see Michael T. Felix, "Preparing the Market for Enhanced Services

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residential customers -- both high and low usage -- benefited from these price declines.³³

Furthermore, the decline in ARPM net of access understates the true magnitude of the benefits delivered to customers because the price declines do not reflect improvements in service quality.

38. Several BOC experts have presented narrow and misleading views of the data attempting to demonstrate a contrary proposition.³⁴ These analyses proceed by selectively choosing individual tariffs or the starting and stopping dates for the time-series, or by relying on flawed telecommunications price indices. A common shortcoming of these studies is a failure to consider adequately the effects of discount programs and other new services on the menu of prices faced by consumers. Because it is a complex task to compare complex baskets of services (*i.e.*, calls which differ by distance, time of day, and enhanced billing and service features), we advocate focusing on the actual prices consumers pay as measured by the average revenue per minute realized by long distance carriers. When performed on this basis, it is

Implementation," *Telephony*, vol. 230, no. 13, page 40), and today, some large customers are obtaining long distance services for as low as \$0.07 per minute (see David large, "VPN Rates on the Way Down," *Network World* 13 (December 2, 1996) pages 1, 14-15).

³³ These data refute allegations by BOC experts that price declines have been narrowly targeted towards a small class of high volume residential users. Today, any residential user need pay no more than \$0.15 per minute for long distance calls, and may actually pay much less depending on the time of the call and the caller's usage patterns.

³⁴ For example, see Paul W. MacAvoy, *The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Services*, Cambridge: MIT Press (for the American Enterprise Institute), 1996.

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clear that real price declines for long distance services have been substantial; we discuss this in more detail in Section VII below.³⁵

39. Indeed, if long distance competition were as limited and prices were as high as BellSouth claims, BellSouth and other BOCs should have taken advantage of the opportunity provided under the Act of 1996 to offer out-of-region long distance services. To the contrary, the BOCs, with very limited exceptions, have declined to provide out-of-region long distance service. At the same time, the BOCs have entered a myriad of other businesses outside of their own regions, including wireless, yellow pages and internet services.

4. Marketing and advertising programs demonstrate vigorous competition.

40. The close causal association between effective competition and the price declines noted above is directly observable from the advertisements and marketing strategies employed by long distance carriers. Each of the major carriers has offered innovative discount pricing proposals, all of which emphasize savings as an important if not the most important

³⁵ See *True Competition in the Long-Distance Market*, MCI Communications Corporation, white paper, January 27, 1997, for additional data supporting these same conclusions. For further discussion of the state of long distance competition, see B. Douglas Bernheim and Robert D. Willig, *The Scope of Competition in Telecommunications*, note 24, *supra*; David L. Kaserman and John W. Mayo, "Competition and Asymmetric Regulation in Long-Distance Telecommunications: An Assessment of the Evidence," note 24, *supra*; R. Glenn Hubbard and William H. Lehr, *Improving Local Exchange Competition: Regulatory Crossroads*, note 13, *supra*; Ingo Vogelsang and Bridger M. Mitchell, *Telecommunications Competition: The Last Ten Miles*, Cambridge: MIT Press (for the American Enterprise Institute, 1997); Long Distance Market Shares Fourth Quarter 1997, FCC Common Carrier Bureau, Industry Analysis Division, released March 1998.

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inducement to customers.³⁶ Although many of these programs are targeted to particular classes of consumers, there are programs for every group. The many residential calling programs (*e.g.*, block-of-time plans, discounts for frequently called numbers, and tie-ins to mileage plans) demonstrate that the benefits of these programs are widely available to all customer segments.³⁷

41. Furthermore, the pattern of innovation and pricing indicates that there is not a clear market leader. AT&T has been forced to respond to new programs from MCI and Sprint as often as the other way around, and more important, the smaller reseller firms have often forced the big three to play catch-up. According to some industry analysts, Sprint's move to introduce simplified flat per-minute pricing is motivated both by a desire to respond to consumer demand and to respond more effectively to reseller competition.³⁸ AT&T has responded with its own "One Rate" plan offering calls for a flat rate of \$0.15 a minute regardless of distance or time of day. In addition, for a \$4.95 monthly fee, it offers a \$0.10 a minute rate at all times. MCI has also responded with a flat rate of 12 cents at all times to customers who make over \$15.00 a month in calls, and it currently offers all residential

³⁶ For example, consider AT&T's "1-800-COMPARE" and MCI's "Proof Positive" programs which allow customers to compare prices directly.

³⁷ According to B. Douglas Bernheim and Robert D. Willig, note 24, *supra*, Chapter 2, page 57: "Industry analysts estimate that, overall, 50 percent of residential users are enrolled in some discount plan, and that these customers account for 75 percent of residential revenues; other estimates place the fraction of long distance customers using discount plans as high as 80 percent."

³⁸ *Ibid.*, page 65.

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customers a \$.05 minute rate on Sundays. In turn, Sprint now offers \$50.00 a month of free calls on Monday evenings.

5. Competitiveness of wholesale long distance services precludes market power.

42. The competitiveness of long distance services is further enhanced by structural features of the market. Extensive excess capacity for bulk transport is available from multiple suppliers, which guarantees the existence of competitive wholesale markets.³⁹ The ability to purchase essential inputs in competitive wholesale markets eliminates an important source of potential entry barriers. That is, bulk transport services will be available at efficient, cost-based prices (*i.e.*, at prices that approximate the long-run, forward-looking incremental cost of providing long distance facilities). This outcome, in turn, implies that flexible reseller entry can quickly exploit and eliminate any arbitrage opportunities which may temporarily arise if retail prices rise above efficient, incremental-cost-based levels.

43. The competitiveness of bulk wholesale markets is one of the most potent

³⁹ The FCC has generally concluded that the market for business services is competitive. In 1991, the FCC found the outbound business services market segment to be "substantially competitive" based principally on its findings "that the business services marketplace is characterized by substantial demand and supply elasticities." (See Report and Order, *Competition in the Interstate Exchange Marketplace*, 6 FCC Rcd. 5880, 5887 (1991)). This finding was recently reaffirmed (see *In the Matter of the Motion of AT&T Corporation to be Reclassified as a Non-Dominant Carrier*, 11 FCC Rcd. 3271, 3318 (1995)). The FCC made the same finding with respect to inbound (*i.e.*, 800) services in 1993, once 800 numbers were made portable (see Second Report and Order, *Competition in the Interexchange Marketplace*, 8 FCC Rcd. 3668 (1993)).

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structural guarantors of effective and aggressive competition for retail services. Moreover, the availability of bulk transport services in wholesale interLATA markets is not comparable to the volume-discounted services offered to high-usage customers in local exchange markets. In long distance, bulk transport may be used as an input to offer a wide array of retail long distance services; it is therefore more akin to the prospective market for unbundled network elements than to that for existing local services. While all of the inputs necessary to offer long distance service are presently available in competitive markets, the same cannot be said for local exchange services.

44. Furthermore, while the Interexchange Carriers (IXCs) actively attempt to differentiate their offerings in terms of discount structures (*e.g.*, AT&T's True USA versus MCI's Friends and Family 2) and in terms of quality (*e.g.*, AT&T's True Voice), the focus of retail competition remains on price. Some BOC experts have argued that these attempts favor price collusion rather than price competition.⁴⁰ They argue that IXC services are relatively homogeneous and that their costs are similar, and that via the tariff process, the IXCs coordinate their pricing decisions to avoid active competition. Putting aside both the fact that such collusion is against the law and that it is contrary to actual experience of long distance competition, arguments for collusion rest on a number of theoretical and factual errors.

⁴⁰ See Paul W. MacAvoy, note 34, *supra*. BOC experts do not explain why colluding IXCs do not raise prices further since the average price elasticity of demand for long distance services is generally estimated to be significantly less than unity in absolute value.

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45. First, the availability and use of complex discounting programs makes implicit price collusion extremely difficult because the carriers do not observe the acceptance rates for each other's discount programs. Such differentiation is even more extensive in the bulk wholesale services (*e.g.*, long-term contracts and Tariff 12 offerings), which helps assure the competitiveness of retail toll services.

46. Second, while local exchange access costs do comprise a significant share of IXC costs (and reflect a subsidy to BOCs), there are many sources of cost heterogeneity reflecting technological differences and differences in marketing costs.⁴¹ These differences are especially relevant for competition in the wholesale markets for bulk bandwidth where specialized facilities-based competition is prevalent.

47. Third, the pattern of similar pricing changes which has been erroneously dubbed "lock-step pricing" is consistent *both* with collusion (as the BOCs claim) and with competition (as all of the other evidence suggests).⁴² Furthermore, in a competitive environment, similar moves in the tariff for basic rate services can be explained easily as a rational marketing response necessitated by the need to avoid confusing consumers who are attempting to evaluate alternative discount programs. Consider the marketing problem of selling in the presence of a

⁴¹ See B. Douglas Bernheim and Robert D. Willig, note 24, *supra*, Chapter 2, page 49; and *Declaration of R. Glenn Hubbard and William H. Lehr*, note 24, *supra*.

⁴² For example, common cost shocks should elicit similar pricing responses under many market structures.

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competitor who offers a larger discount (on which consumers are most likely to focus) from a generally higher basic tariff (which few consumers ever read). Because the principal competitive efforts of the IXCs are focused on differentiating their products via discount or enhanced-service offerings, these offerings ought to be the focus of an analysis of pricing behavior.⁴³

48. Fourth, the alleged success of AT&T, MCI, and Sprint to collude on prices to earn excess margins would provide a potent inducement for expansion by existing competitors such as Worldcom, Excel, or Frontier, and would attract new entry into the market (for example, from out-of-region BOCs, CAPs, or cable television carriers).

49. To summarize, the structural features of long distance services encourage aggressive competition.

50. This competitive situation is quite different from that in local exchange markets. In local markets, almost all of the capacity is controlled by a single carrier. Today, with the BOC entry restriction into in-region, interLATA services in effect, the BOCs have an incentive to provide non-discriminatory access services to all long distance carriers. As we discuss further below, this incentive disappears once the BOC becomes a long distance competitor.

⁴³ As we noted earlier, this point explains why simplistic comparisons of tariff schedules should be avoided. A better measure of pricing trends is provided by comparing average revenue per minute trends, which reflect the weights of actual market demand, rather than arbitrary weights selected to support an advocacy analysis. Furthermore, higher basic rate service is likely to encourage accelerated migration to the new service offerings which is in keeping with the desire of IXCs to differentiate their products.

The recent behavior of Southern New England Telephone Company (SNET) and GTE illustrates this phenomenon. AT&T has filed a complaint against SNET for its discriminatory behavior marketing its long distance services in Connecticut,⁴⁴ and GTE has been delaying interconnection negotiations with AT&T, severely hindering AT&T's ability to provide local service.⁴⁵

6. Customer switching among carriers demonstrates consumer sovereignty.

51. Potent evidence of consumer sovereignty is provided by the pace with which customers shift among long distance service providers. This provides a better measure of the level of competitiveness of a market than a simple comparison of overall market shares. For example, AT&T experienced 19 percent churn in 1992, and subscribers changed long distance

⁴⁴ See *Petition of AT&T Communications of New England, Inc. for Review of the Southern New England Telephone Company's Local Office and Other Practices*, filed September 9, 1996, Docket No. 96-09-05. The anticompetitive behavior of SNET is discussed further, *infra*, at Section V.A.

⁴⁵ See *Direct Testimony and Exhibits of Russell D. Morgan on Behalf of AT&T Communications of the Southwest, Inc. in connection with SOAH Docket No. 473-96-1191, PUC Docket No. 15711 (Complaint of AT&T Communications of the Southwest, Inc. Against GTE Southwest, Inc., et al.)*, page 28.

carriers over 42 million times in 1995.⁴⁶ The rate of churn rose further still in 1996, with 53 million changes in long distance carriers.⁴⁷

52. To summarize, available evidence points to the conclusion that competition in long distance services is quite vigorous.

B. Competition in Local Exchange Markets

1. Competition in local exchange markets is presently lacking.

53. Consideration of similar data used to evaluate the competitiveness of long distance markets yields a starkly different conclusion: Markets for local exchange are not competitive presently. With the exception of a few niche markets, customers can purchase local exchange services from only one firm (Exhibit 7). The BOCs have a *de facto* monopoly that grants them significant market power over facilities that are essential for competition in both long distance and local telephone markets.

⁴⁶ See B. Douglas Bernheim and Robert D. Willig, note 24, *supra*, Chapter 2, page 67. The estimated churn rate of 19 percent is based on the share of AT&T revenue associated with customers who left AT&T for another carrier or who left another carrier for AT&T.

⁴⁷ Based on estimates provided by AT&T.

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54. The lack of competition in the local exchange markets can be seen starkly in price trends in those markets. In contrast to prices for long distance services, prices for local services have increased (see Exhibits 8A and 8B).⁴⁸ According to a recent study by the Consumer Federation of America, the ILECs are "earning \$4.5 billion annually in charges resulting from excess profits at the expense of captive telephone ratepayers."⁴⁹

55. This study goes on to show that local phone rates have increased in recent years, despite the fact that the overall cost of providing service has been declining.⁵⁰ Monopoly

⁴⁸ The data in Exhibits 8A and 8B show that the Consumer Price Index (CPI) and the Producer Price Index (PPI) for local service have increased (even relative to the CPI for all goods and services), while the indices for long distance toll services have actually declined. Moreover, this relative disparity is understated because the CPI and PPI inadequately account for discount programs, which are much more important for long distance services than for local services.

Because the PPI was revised in June 1995, it is not possible to compare the new indices with the data in Exhibit 8B; however, as of April 1997, the new PPI indices for residential local and business services have not declined since June 1995 (see Table 5.7 of the *Monitoring Report*, prepared by the Federal-State Joint Board, CC Docket No. 87-339, May 1997).

⁴⁹ See "Study Finds \$4.5 Billion in Annual Excess Profits for Local Monopoly Telcos," Press Release from Consumer Federation of America, September 18, 1996, page 1. The press release summarizes results from a report by Mark N. Cooper, "Excess Profits and the Impact of Competition on the Baby Bells," Prepared for the Consumer Federation of America, Washington, D.C., September 1996.

⁵⁰ The study concludes by stating: "The pressures put on regulators by the Baby Bells is certain to be vigorous, but the evidence is compelling that if regulators do the right thing, the initial impact of competition will be to restore Baby Bell profits to reasonable levels and create a level playing field for competition." See Mark N. Cooper, note 49, *supra*.

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profits support cost inefficiencies⁵¹ and provide the BOCs with a war chest from which to fund anticompetitive activities. To quote BellSouth:

"[T]he dominant incumbent, if it fails to accept the benefits which flow from a competitive market, can and will rationally use interconnection negotiations to delay and restrict the benefits of competition.... A dominant incumbent can limit both the scale and scope of its competitors, raising their costs and restricting their product offerings. In addition, it can divert or delay competition and innovation to protect its current revenues..."⁵²

56. In recognition of their dominant position, BOCs such as BellSouth are subject to substantial regulatory oversight from state commissions and the FCC. This ranges from

⁵¹ According to BellSouth, "monopoly-bred inefficiency plays into the incumbent's hands by (1) enabling dramatic improvements in operating results through relatively easy 'fatcutting,' and (2) justifying high interconnection prices designed largely to recoup the incumbent's past inefficiencies" (see *Comments of BellSouth Europe to the European Commission's Green Paper on the Liberalization of Telecommunications Infrastructure and Cable Television Networks*, BellSouth Europe, March 15, 1995, page 5).

⁵² See *Regulation of Access to Vertically-Integrated Natural Monopolies*, discussion paper, BellSouth New Zealand, September 1995, page 2. Later the same report argues that it is rational for the incumbent:

"to exploit the regulatory regime to the greatest possible extent without exposing itself to the threat of intervention or adverse changes to the regime. In fact, the directors of the dominant incumbent have a fiduciary duty to seek to extract the highest rents available to it as a result of its business position (as does any other profit-maximizing firm).... It has very powerful incentives to include monopoly rents in the price of complementary network services in order to perpetuate and increase its monopoly profits. It similarly has powerful incentives to reduce the ability of its competitors to claim market share."

Ibid., page 10.

traditional rate-of-return regulation in some states to more indirect forms of oversight in other states. The Telecommunications Act of 1996 anticipates the eventual deregulation of all telecommunications services, once effective competition makes regulatory oversight unnecessary.

57. CAPs such as Metropolitan Fiber Systems (MFS) and Teleport typically have aggressively competed for the particular services of a segment of customers in a subset of markets. These are principally the access services demanded by large commercial customers in major metropolitan areas, and most often located in large office buildings. To the extent they are now seeking to provide service as CLECs as well, they are largely pursuing the same limited customer base. Therefore the CAPs are irrelevant to the vast majority of customers in most markets, most particularly residential customers.⁵³

58. Some progress, however, is being made toward introducing local competition. The CAPs and CLECs are investing substantial amounts to enter local services (see Exhibit 9), but much greater investments are required before the CLECs can offer meaningful facilities-based competition. For example, in 1996, the total telecommunications plant in

⁵³ The CAPs' principal market opportunity has been to provide special access (*i.e.*, dedicated access) and private line services in many cases to long distance carriers to interconnect their points of presence (POP) and the BOCs' switching centers. This has been feasible because these are the services which depend least on cooperation of the BOCs and rely least on the BOCs' facilities. Therefore, CAPs are less vulnerable to anticompetitive practices by the BOCs.

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service for all local exchange companies was \$292 billion.⁵⁴ In 1996, the LECs had 23,661 central office switches, 159 million local access lines, over 2.5 billion kilometers of copper wire, and gross plant investment expenditures of \$22.4 billion.⁵⁵ Matching this level of installed plant facilities will take time.

59. The progress of local competition will be aided by continued advances in local access technologies that permit wireless and other alternatives⁵⁶ to the copper loops provided by the ILEC. Early versions of these technologies are being deployed on a limited basis,⁵⁷ but viable, commercial-scale alternatives to using the incumbent's local access facilities do not yet exist. Therefore, the market power of the BOCs will persist for some time.

60. Thus, while local competition is emerging, there is no significant competition that can constrain the market power of the incumbents at the present time. Such competition

⁵⁴ Total telecommunications plant in service for the local exchange companies was \$292 billion (Table 2.7) compared to total communications plant of \$55.4 billion for interexchange carriers (Table 2.1) (see *Statistics of Communications Common Carriers 1996/1997*, Federal Communications Commission, Washington, DC, December 1997).

⁵⁵ See *Statistics of Communications Common Carriers 1996/1997*, note 54, *supra*, Tables 2.4, 2.3, 2.2, and 2.7 respectively. The kilometers of copper wire are those in non-coaxial cables. The gross plant investment is the total telecommunications plant in service added during 1996 by all reporting LECs.

⁵⁶ These include using existing wireline infrastructure associated with electric utility networks or cable TV networks to transport telephone traffic to consumer households. Use of these networks, however, requires significant investments to upgrade facilities.

⁵⁷ Such investments as have been undertaken by cable companies seem more intent on offering high speed internet access service than on competing with the ILECs.

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as the incumbents face is limited to commercial customers in major metropolitan areas. For widespread competition to emerge for residential customers and all customers outside of high density areas, it is essential to implement the pro-competitive network unbundling requirements of the Act. The failure of the BOCs to demonstrate adequately that these policies have been successfully implemented in any state thus far indicates how premature it would be to permit the BOCs to participate in interLATA services at this time.

2. There is no effective local competition in Louisiana.

61. Louisiana provides no exception to the BOCs' monopoly control of local exchange markets. BellSouth currently faces essentially *no* facilities-based competition for residential customers.⁵⁸ BellSouth has unbundled only about 100 loops for business customers and unbundled no loops for residential customers.⁵⁹ Facilities-based CLECs provide service on only about 0.19% of the access lines in BellSouth's Louisiana service territory.⁶⁰ Even if resale is taken into account, BellSouth continues to provide the exclusive service on about 98% of the access lines in its Louisiana service territory.⁶¹ In sum, BellSouth controls

⁵⁸ *Affidavit of Gary M. Wright on Behalf of BellSouth*, in the Matter of Second Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-region, InterLATA Services in Louisiana, Before the Federal Communications Commission (July 1998), Exhibit C-CLEC.

⁵⁹ *Ibid.*

⁶⁰ *Ibid.* ¶ 61 and Exhibit C-CLEC.

⁶¹ *Ibid.* ¶¶ 57, 60-61, Exhibit C-CLEC.

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all but a *de minimis* portion of the access lines in its service area, and customers in BellSouth's Louisiana service areas have no realistic choice in selecting their provider of local exchange service. The presence of PCS providers or the "proximity" of other carriers' networks to BellSouth customers do not alter this critical fact.

a. PCS wireless service is not a viable alternative to wireline service in today's markets.

62. Mr. Denk and Dr. Banerjee both submit affidavits that address the potential of PCS wireless services to offer effective local competition to BellSouth. Presumably, the intent of providing this evidence is to demonstrate that there is already effective local competition, irrespective of the status of implementation of the Telecommunications Act of 1996.⁶² Both Mr. Denk and Dr. Banerjee are quite circumspect in their claims regarding the ability of PCS to offer effective competition today, claiming only that there are a subset of current subscribers who seem to find PCS a viable alternative to wireline service from BellSouth. Their circumspection is understandable because it is clear that, while PCS or some other wireless technology (*e.g.*, Local Multipoint Distribution Service, or LMDS) *may* offer a viable alternative to wireline service in the *future*, PCS is not a viable alternative *today*.⁶³

⁶² Therefore, this argument does not bear on an assessment of whether non-PCS competitors are able to effectively utilize the pro-competitive unbundling and interconnection provisions required by the Act.

⁶³ According to one industry expert and strong believer in the future potential of wireless, "it's going to be a few years before we really see any wireless local loop on a grand scale." See Wilson Dizard, "Wireless Profits Seen Flowing Despite Price Pressures," *TR Wireless News*,

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BellSouth's own data place the current PCS penetration rate at approximately 1.5 percent.⁶⁴

Moreover, even this penetration figure overstates the numbers of people who are using PCS as a substitute for wireline service. BellSouth's own survey results indicate that, among the very small numbers of current PCS users, only six percent (four percent of personal users) have replaced their residential wireline phones with PCS service, a figure that is down by four percent from August 1997.⁶⁵

63. Additional evidence that PCS is not viewed today as a substitute for wireline service (except perhaps by a small niche minority) is how it is marketed. AT&T does not distinguish between its PCS and mobile cellular offerings -- referring to both offerings as Digital PCS Services.⁶⁶ PCS providers are positioning the service as an alternative or extension to *mobile* wireless services, not *fixed* wireless or wireline.

64. Because of the limited cellular competition heretofore, the higher cost of providing high speed mobility, and the higher value that cellular users place on mobility,

October 30, 1997.

⁶⁴ See *Affidavit of Gary M. Wright on Behalf of BellSouth*, paragraphs 34 and 61. See also Angela Littwin, "The Great PCS Buildout: a status report," *Telecommunications*, vol. 31, no. 4, April 1997. According to Ms. Littwin: "The realities of implementation have set in -- rollouts have been slowed; roaming capabilities are being added gradually; coverage is far from complete. Carriers are struggling with huge start-up costs, potential over-competition, and antenna-siting problems."

⁶⁵ See *Affidavit of William C. Denk on Behalf of BellSouth*, page 8, Table 4, note 10, *supra*.

⁶⁶ See *Affidavit of Jordan Roderick* being filed along with our affidavit.