

in providing even purely local services is profitable, notwithstanding regulation.<sup>46</sup> At the same time, the BOC could value entry authority into long distance; for example, its strong brand name locally and ability to realize cost savings through joint retailing functions could allow it to earn profits in long distance (section II C). Therefore, to receive long-distance authority it would be willing to extend some cooperation to local entrants. Granting such authority before the local market is open, however, will prematurely reduce the BOC's incentives to continue cooperating in opening its market.

### C. Artificial Cost Advantage in Competing for Long-Distance Services

121 Among the concerns voiced by major IXCs is that a BOC would have artificial cost advantages in competing for long-distance business because their access prices to IXCs are well above cost.<sup>47</sup> The IXCs are right that even if imputation rules required a BOC to charge its affiliate the same access price as it charges IXCs, an affiliate would treat such a price as merely an internal transfer, and would try to base its retail prices on the true cost of obtaining access.<sup>48</sup> A BOC's

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<sup>46</sup> This requires only that price regulation not be capable of reducing prices perfectly to cost, hardly a stringent assumption. Perfect "global price-cap" regulation might in theory eliminate incentives to discriminate against competitors. See Jean-Jacques Laffont and Jean Tirole, "Creating Competition through Interconnection: Theory and Practice," February 1996, forthcoming in *Journal of Regulatory Economics*, and "Global Price Caps and the Regulation of Interconnection," July 1996. But in practice price caps are never pure, so allowing entry is likely to end up hurting the firm by ultimately contributing to the tightening of price caps. It is true that the incumbent's incentive to cooperate with output-market competitors may well be greater if it could sell to them the inputs they require at unregulated rather than regulated prices. But even then, the incentive is likely to be inadequate. Once competition is established, it limits the ability to extract profits from customers, it is highly unlikely—for reasons involving contracting problems or antitrust—that the incumbent could collect sufficient profit through overpricing of inputs to competitors initially to offset these lost future profits. Predictably, dominant incumbents often resist entry into their markets.

<sup>47</sup> Responses to Joel Klein letter by AT&T (p.21), MCI (pp. 9-10), Sprint (p.3), December 1996. The FCC's recent actions on access charges and price caps, while helping to bring down access charges, do not purport to bring them down to cost and in fact are likely to leave them well above costs for some time. Moreover, intrastate access charges, which now typically exceed interstate charges, will remain under the jurisdiction of state commissions and considerable uncertainty remains about their levels. Thus, the issue raised by the IXCs remains pertinent.

<sup>48</sup> The IXCs are implicitly assuming that imputation rules would not be capable of seriously constraining a BOC affiliate's retail prices. This assumption is probably realistic, given the difficulties of comparing the other relevant variables necessary to conduct an imputation test. (The test prohibits  $p \leq c + w + d$ , where  $p$  is the affiliate's retail price,  $c$  the affiliate's cost of non-bottleneck inputs,  $w$  the input price to its rival, and  $d$  the firm's extra cost of providing the bottleneck inputs to the rival than to the affiliate. In practice, estimating  $c$  and  $d$  can

affiliate would then be able to undercut IXCs' prices selectively to certain customers and capture such business even if it is inherently less efficient than IXCs

122. The IXCs' argument is correct as far as it goes. But it overlooks the fact that selective discounts by a BOC could well increase total long-distance output and benefit consumers. One must be clear about the alternatives being compared. Assuming that access charges by BOCs to IXCs would be no higher if BOC entry is authorized than if it is not, an assumption discussed below, a BOC's ability to offer selective discounts should increase total long-distance output and benefit long-distance consumers, as compared with barring BOC entry. (This assumes that BOC entry does not induce IXCs to exit the market as a result of being unable to profitably operate at a reduced scale. If exit does occur, a BOC may be able to raise price.) The basic reason is that IXCs' cost has not increased—because by assumption access prices are no higher—but a new competitor (the BOC) enjoys lower cost of serving the long-distance market (albeit artificially lower, because it charges to IXCs access prices well above its own incremental cost of providing access, while basing its own retail pricing behavior on the latter).<sup>49</sup>

123. The assumption that regulation will prevent a BOC from subsequently raising access prices to IXCs (or failing to lower them as much as would otherwise have occurred) is important, however. In particular, there are dangers of regulating access pricing by including in a common basket both access services "sold" to the BOC's affiliate and to IXCs and subjecting the basket to an overall price cap. By lowering the price to its affiliate a BOC would then be allowed to raise prices to IXCs while adhering to the cap, the BOC gains, of course, since the additional profits earned by its affiliate are unregulated. Thus, a BOC will have strong incentives to try and give its affiliate preferential discounts, in order to justify raising the access prices charged to IXCs.

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be especially problematic, even agreeing on the relevant services to be used when comparing  $w$  and  $p$  can be contentious.) Moreover, there is a general question about the wisdom of zealously enforcing any price floors. Such policies can easily stray from protecting competition to protecting competitors.

<sup>49</sup> Observe that the concern is not with the BOC raising the access price or engaging in access discrimination against IXCs, but with reducing its retail price given that access to IXCs is priced above cost.

124. The Act and current regulation prohibit such discrimination in access pricing. However, a BOC may plead "nondiscrimination" by designing discounted offers that are nominally available to all but are targeted to its affiliate. It can make discounts conditional on terms that (a) are alleged to provide cost savings and (b) are contrived such that the affiliate is more likely to accept, for example, a buyer's agreeing to make very long-term purchase commitments.<sup>50</sup> The scope for such gamesmanship can be reduced by having separate price caps for access services sold to competitors and to affiliates. And in general, if competitively significant "nondiscriminatory" discounted offers are disproportionately accepted by affiliates, some scrutiny may be warranted of whether discounts reflect genuine cost savings.<sup>51</sup>

125. In sum, I would be reluctant to advocate delaying a BOC's interLATA entry solely on the grounds that its access prices to IXCs are currently well above its incremental cost—as long as the BOC can adequately be prevented from raising access prices to IXCs post entry.<sup>52</sup> It is certainly true, however, that the best course is to reduce access charges closer to cost. Assuming that (non-price) access discrimination could be prevented, reducing access prices would both expand downstream output and prevent distortion of competition.

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<sup>50</sup> Of course, discounts for long-term commitments can reflect legitimate business reasons. In the guise of such reasons, however, one also could contrive contracts of such long duration and such stringent terms for breach that only an affiliate would feel comfortable accepting. An affiliate would realize that if changed circumstances made it efficient to breach its commitment, it would be allowed to do so (in the interest of maximizing overall firm profit) far more readily than would an outsider such as an IXC. A BOC also might try to rationalize discounts based on the percentage of a long-distance carrier's minutes committed to the BOC. An IXC might value the option of flexibility, such as splitting its minutes between a BOC and a CAP (especially if CAPs continue to expand), while a BOC's affiliate would far more readily accept exclusivity with the parent.

<sup>51</sup> Unfortunately, it is not easy to police against true price discrimination when buyers require significantly different arrangements, leading to potentially different costs of service. See, for example, Marius Schwartz, "The Perverse Effects of the Robinson-Patman Act," *Antitrust Bull.* 31 (Fall 1986), 733-757.

<sup>52</sup> Authorizing BOC entry, of course, does not foreclose subsequent antitrust action if price squeezes are deemed to be anticompetitive.

#### IV. The Ability of Regulatory Safeguards to Negate Concerns Raised by BOC Entry

126. Based on the preceding analysis, the main potential competitive concerns raised by BOC entry are access discrimination against long-distance carriers and, especially, the withholding of cooperation in implementing and pricing appropriately the various new wholesale local services. How serious these potential concerns in fact are depends on how effectively and expeditiously they can be addressed by regulatory and other safeguards. Section A below discusses generic shortcomings of regulation, showing by implication that there is real value to having a BOC be more disposed to cooperate than having to rely exclusively on forcing its cooperation. Nevertheless, while never perfect, regulatory and other safeguards are far more adept at preventing degradation of established access arrangements than at forcing implementation of new arrangements, this difference has key implications for the design of a pro-competitive standard for BOC entry (see section V). Sections B and C document this difference drawing on past experience with LEC behavior.

##### A. Generic Shortcomings of Regulation, and Existing vs. New Arrangements

127. Regulation faces several inherent shortcomings in trying to curb a firm's incentives to discriminate against competitors, which caution us against relying on it exclusively.<sup>53</sup>

##### 1. Generic shortcomings of regulation

128. *Detecting abuses* In order to be effective, regulators must be able to detect a violation. This requires knowing, among other things, what the firm actually did (not what it claims) and often what alternatives it could have pursued. Outsiders such as regulators, courts, and even competitors possess vastly inferior information than the firm about its business environment and conduct. And while a regulator can learn a great deal by consulting with interested industry parties, to eliminate the informational disadvantage entirely the regulator would have to become the firm.

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<sup>53</sup> For good discussions of the limitations of state and FCC regulation prior to the 1996 Act, see the December 1994 Declarations of Nina W. Cornell (focusing on state regulation, especially pp. 35-63) ("Cornell, 1994") and of Daniel Kelley (FCC regulation, especially pp. 37-75) opposing the motion by four BOCs to vacate the MFJ. *United States of America v Western Electric Company, Inc. and American Telephone and Telegraph Company*, United States District Court for the District of Columbia, Civil Action No. 82-0192.

129. *Proving abuses.* Detecting a violation is not the same as being able to prove it. Regulated firms enjoy—for good reasons—procedural safeguards including the right, which they often exercise, to challenge regulatory decisions in court. A non-specialist court is likely to be less informed about conditions in the industry than is a regulator, and the adversarial court proceedings offer the better-informed firm ample opportunity to raise various objections. Thus, even if a regulator is convinced there is a violation, proving it to the standard needed to take corrective action may be too costly or simply not feasible.

130. The issue of proof is important. The BOCs have repeatedly argued that preventing discrimination is easy because a service difference great enough to influence the behavior of customers assuredly would be detected by competitors and by regulators. However, simply showing such a difference is not sufficient to prove a BOC has discriminated, especially with new or customized arrangements—there could be “innocent” explanations with a sufficient ring of plausibility (different circumstances of transactions, events beyond the firm’s control, etc.). Indeed, a major advantage of competition over regulation in taming market power is that a competitor is not constrained by the same rules as a regulator: if a competitor believes the incumbent’s price is excessive or its service is inferior it can simply offer customers better options—without having to prove to anyone that the firm is misbehaving.

131. *Deterring abuses.* Effective deterrence requires the expected penalty to exceed the expected gain from engaging in an abuse. The requisite penalty may have to be large given (a) the potentially large gains to a firm and (b) the limited chance that a violation will be detected and proved, hence that the penalty will be imposed. Regulators may not always have the legal rights or the political ability to impose penalties large enough to achieve meaningful deterrence. Imposing high penalties is especially problematic when violations are not demonstrably blatant, as is likely with new (as opposed to established) access arrangements.

132. *Correcting abuses.* Since deterrence will not be perfect, a regulator also must be able to rectify the effects of abuses quickly and effectively. But the damage to a competitor imposed, for example, by technical discrimination can be difficult to reverse: discrimination may have allowed the regulated firm to beat the rival to market with a new product. This first-mover advantage could have

a durable impact, for example, if consumers would have to incur significant switching costs should they wish to move to the entrant. (For this reason, the Act tries to minimize these costs through such means as requiring number portability.)

133. *Cost-effective regulation* Finally, regulation would have to accomplish the above tasks in a cost-effective manner. It does little good to prevent abuses if doing so means intruding into the firm's decisions to a suffocating degree, or expending vast resources on regulation. As a practical matter, the resources made available to regulators may limit their ability to engage even in the efficient degree of oversight. The FCC and state commissions are operating under tight budgetary and personnel constraints that may not be commensurate with their responsibilities: the new Act has vastly increased the FCC's duties, and state commissions must grapple also with the rapidly changing electric utility industry.

## 2. Existing vs. new arrangements

134. Assuring equal access to BOC local networks—for both long-distance carriers and local competitors—in the face of reduced BOC incentives to cooperate requires policing against sins of *commission* and *omission*: a BOC might attempt to reduce cooperation from existing levels by degrading existing access arrangements, or fail to provide a greater level of cooperation as it should in establishing new arrangements.

135. It is difficult for regulators to eliminate entirely even sins of commission—the degradation of existing arrangements.<sup>34</sup> Nevertheless, once arrangements are in place and there is some track record against which to benchmark “good behavior,” preventing access discrimination becomes much more manageable.

136. Conversely, enforcing the implementation of new arrangements is much harder. It is particularly difficult to prevent such sins of omission, since there are no good historical benchmarks to guide what is feasible for the firm. Implementing the new Act's local-competition requirements

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<sup>34</sup> For example, requiring a BOC to meet “objective” performance measures such as average provisioning intervals is not a perfect safeguard. A BOC could discriminate while showing identical average intervals for its affiliates and outsiders, because the same average can conceal important variations: when it is very important for an IXC to get rapid service the BOC can delay it, while meeting the overall average requirement by providing expeditious service when the IXC least needs it.

of interconnection, unbundling and resale will require dramatic and wide ranging changes in the way a LEC does business. For example, loop unbundling will require physical (not just electronic) changes. And new electronic interfaces will be needed to coordinate ordering, billing and other functions for carriers that resell a BOC's local service. With reduced incentives to cooperate once allowed into long distance, a BOC could delay such arrangements considerably. It may initially refuse to provide a new arrangement, citing prohibitive costs, then relent and "merely" delay or give priority to requests from its affiliate to place it at a competitive advantage. The point is not that such excuses are never true, but that it will be difficult for regulators to discern which are true and which are not.

#### **B. Enforcing Existing Access Arrangements**

137 By and large, the U.S. experience with participation by regulated LECs in long-distance markets suggests that once access arrangements for competitors are established, subsequent problems become much more manageable. To cite a recent example, IXC's have made substantial inroads competing for intraLATA toll services in states such as Minnesota and Alaska that had implemented intraLATA dialing parity prior to the 1996 Act. I am not aware of backsliding by LECs on providing such dialing parity.

138 It is of course possible that we have yet to see the full arsenal of incumbent responses. IntraLATA dialing parity is a recent phenomenon and incumbents may still be mulling their options. However, certain LECs such as Rochester Telephone (which is part of Frontier), United (which is part of Sprint) and Lincoln Telephone were not subject to the MFJ and have offered long-distance (interLATA) services in competition with IXC's for some time. I understand that IXC's have made few complaints against these LECs about degradation of existing access arrangements.

139 More recently, Sprint has owned Centel in Nevada since 1992, yet IXC's have made no significant complaints to Nevada regulators. Southern New England Telephone Company (SNET) has begun offering interLATA service jointly with its local service, so has GTE since the passage of the Act (which ended the consent decree that prevented GTE's local operating companies from jointly marketing long-distance services). GTE and SNET have been very successful in capturing long-distance business, but neither has elicited serious complaints concerning their degradation of existing long-distance access arrangements for IXC's.

140. In short the scope for a BOC, after allowed interLATA entry, to degrade existing access arrangements used by IXCs is relatively limited in the short run. Most importantly, regulatory and antitrust safeguards can do a far better job of enforcing such existing access arrangements given the long track record of experience with them. In addition, a BOC would face some technical difficulties today in finely targeting for discrimination only pieces of the network that serve IXCs or their customers. Finally, some of the markets which the BOCs are said to target if allowed interLATA entry, low- to medium-volume residential and business customers, are also ones where IXCs require relatively simpler access arrangements.<sup>55</sup>

### C. Implementing New Access Arrangements

#### 1. IntraLATA toll dialing parity

141. The main long-distance markets in which the BOCs have participated since the MFJ are those for intrastate, intraLATA toll services. Dialing parity—the ability to reach a carrier other than the LEC without dialing additional digits—is very important to subscribers who must dial manually, such as most residential subscribers and small businesses lacking a PBX. Indeed, LECs consistently opposed dialing parity on the grounds that implementing it would cause them to lose massive amounts of traffic. Until a few years ago, no BOC provided dialing parity anywhere. Often regulators did not seek to enforce dialing parity (partly on grounds of protecting this LEC revenue in order to support cross-subsidies of other services such as basic residential access and most services in rural areas). But even where they did, incumbents successfully delayed the process through protracted appeals.

142. The case of Minnesota is instructive.<sup>56</sup> The Public Utilities Commission (PUC) determined in October 1985 that dialing parity to IXCs for intraLATA toll calls (through “1+ presubscription”)

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<sup>55</sup> About 80% of LECs' interstate access revenues comes from switched traffic (Table 1, note 6), where access arrangements are largely standardized. Dedicated access is used mainly by large customers, and competition from CAPs and CLECs is developing faster for such dedicated arrangements. However, if local competition fails to develop for broader segments of the market, the BOCs if allowed into long-distance could pose a growing threat to access arrangements used by IXCs: new arrangements will become increasingly necessary, and local networks might be re-configured to permit more subtle forms of access discrimination.

<sup>56</sup> The ensuing discussion draws on Cornell (1994), and on interviews conducted by the Department of Justice. My purpose here is not to single out the Minnesota Public Utilities Commission or the incumbent BOC, U S West, but to illustrate generic problems.

was in the public interest, and in November 1987 created a committee to develop an implementation schedule and a means of paying the costs of presubscription. U S West, the incumbent BOC, asked the PUC to reconsider its public interest finding, but was denied in January 1988. In June 1989 the study committee filed a report stating that presubscription could be done and proposing a method of implementation and funding.

143. In September, 1992, U S West again petitioned the PUC essentially to reconsider its decision that presubscription was in the public interest. The PUC denied the request but reconvened the study committee, having decided that the earlier report might be outdated. The committee submitted an updated report in August, 1993. In July, 1994, the PUC set implementation guidelines for intraLATA equal access by incumbent LECs not already providing it. After further unsuccessful efforts by U S West to challenge the PUC's order in court, intraLATA presubscription was finally implemented in February 1996—over a decade after the PUC had determined that it was in the public interest.

144. This episode, and others like it, are all the more striking given that claims challenging the technical feasibility of dialing parity had long been refuted. In exchanges serving most traffic in Alaska dialing parity was implemented in 1991-92. GTE implemented a comparable capability for itself in Hawaii in 1986, but only in July 1996 did the Hawaii PUC compel it to provide intraLATA dialing parity to others. Thus, technological uncertainty is not the sole problem; incumbents have considerable ability to stall the process through regulatory and legal challenges.<sup>57</sup>

## 2. "Open Network Architecture"

145. One of the toughest challenges to meeting the new Act's local competition requirements will be in assuring competitors access to unbundled network elements. The FCC's experience with attempting to implement Open Network Architecture (ONA), while different in some respects, nevertheless is instructive.<sup>58</sup>

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<sup>57</sup> The BOCs continue to resist intraLATA dialing parity today. For example, in states such as Michigan and Wisconsin where commissions have ordered such parity, Ameritech has mounted numerous regulatory and legal challenges. Technical barriers are sometimes cited, however, Michigan regulators found that 82% of Ameritech switches could be converted immediately, while the remaining ones would require only some software development.

<sup>58</sup> A summary of the main episodes in the history of ONA and the relevant references can be found in the decision *California v. FCC*, 39 F.3d, 919 (9th Cir. 1994).

146. The FCC's *Computer II* rules (1980) allowed BOCs to offer unregulated enhanced services (such as computerized data processing that also require access to telephone networks) only through separate subsidiaries, in part to help prevent access discrimination to telephone networks against competing enhanced service providers. Ameritech proposed an early version of ONA partly as a substitute safeguard against discrimination by offering access to disaggregated network elements which enhanced service providers could use flexibly. ONA would reduce a BOC's ability to discriminate. Other BOCs similarly argued that ONA would void the need for the structural separation required by *Computer II*. The FCC concurred in *Computer III* (1986), it ordered the BOCs to develop plans for ONA and determined that ONA requirements would be "self-enforcing in controlling discrimination."

147. Backsliding from initial ONA promises began almost immediately, though much of this was not conscious discrimination but inevitable in view of the unrealistic expectations initially touted for ONA. And major, protracted controversy ensued over whether the BOCs had actually implemented the reduced version of ONA that they did promise. The FCC, while acknowledging that ONA had not been fully implemented, ruled the BOCs had nevertheless done enough to justify lifting the separate subsidiary requirement. The Ninth Circuit (1994) strongly disagreed, finding that the FCC had failed to explain how these scaled back safeguards, that fell well short of the "fundamental unbundling" originally envisioned in *Computer III*, would suffice to prevent discrimination.

148. There are important differences between the network unbundling envisioned in ONA and that required by the 1996 Act. We have a much clearer idea today of the services local competitors might provide and their requirements than we did then for enhanced service providers. And the technological advances needed for ONA were more pathbreaking than the measures required to implement the Act's unbundling requirements (as spelled out in the FCC's Local Competition Order). Still, ONA offers important lessons: backsliding from initial promises, whether deliberate or not, is likely; and so are disputes over the details of what has—and has not—been implemented. These lessons highlight the dangers of relying on "paper implementation" of new requirements and, to avoid protracted regulatory and legal skirmishes, the importance of authorizing a BOC's interLATA entry

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only after there is enough confidence that it has indeed implemented key local competition requirements.

## **V. Principles for a Procompetitive Entry Standard**

149. At the risk of oversimplification, the stylized pattern emerging from section IV is that once access arrangements are in place and there is a track record against which to benchmark "good behavior," the task of preventing access discrimination becomes much more manageable. It is very difficult, however, to impose new arrangements against the firm's will. These considerations, and the earlier analysis of the potential benefits from BOC entry, lead me to the following principles for a procompetitive BOC entry standard

### **A. Fully Effective Local Competition Is Not a Prerequisite**

150. Withholding BOC entry authority until there is sufficient local competition to eliminate a BOC's market power would not be appropriate on economic grounds. Even if barring the BOCs from long distance was justified at divestiture in order to promote the nascent long-distance competition, such competition could be protected today while allowing BOC entry well before there is effective local competition

151. There are now several major established long-distance carriers. Regulators today are more attuned to risks of discrimination and, importantly, long-distance access arrangements are well established. The new Act prohibits many discriminatory practices that were not specifically prohibited pre-divestiture. In addition and importantly, the Act provides for opening of the local market which over time should yield additional safeguards for long-distance competition, both by providing direct alternatives, and by offering benchmarks to assist regulators in regulating BOC conduct

152. Moreover, the development of local competition—a central goal of the Act—can itself be accelerated by authorizing BOC entry before there is effective local competition, *provided* that such authority is appropriately conditioned on prior BOC cooperation with local entrants. Local competition will develop sooner if the BOCs cooperate, and the BOCs should be more willing to cooperate if in so doing they secure earlier entry into long distance. This logic, I believe, is integral to the particular sequencing adopted in § 271

153. Finally, as noted earlier, BOC entry has the potential to yield significant benefits in provision of integrated services and increased long-distance competition. Since the potential costs can be mitigated through regulatory, antitrust and other safeguards once the market is open and benchmarks are in place, coupled with some local competition, the value of attaining earlier the benefits of BOC entry reinforces the case for approving such entry well before effective local competition is in place.

#### **B. The Local Market Must Be Irreversibly Open to Competition**

154. While section IV showed that regulators can do a reasonable job of preserving established arrangements, it also raised significant doubts about their ability to expeditiously enforce new arrangements in the face of BOC resistance. This is particularly an issue for the new local-competition arrangements required by the Act, many of which entail radical departures from past practice. Given the pivotal role of these arrangements in laying the foundation for local competition as envisioned in the Act, and that local competition holds the key to achieving the Act's goals, I believe that BOC entry should be authorized only once there is sufficient confidence that the BOC's local market has been irreversibly opened to competition through all three entry modes contemplated by the Act. Several steps, discussed next, lead to this conclusion.

##### **1. BOC incentives to cooperate can make a great difference**

155. The BOCs themselves seem quite aware of their latitude, within the regulatory and legislative constraints, to affect the pace and efficacy of the process to open up local markets to competition. The importance of BOC cooperation is illustrated by contrasting the experiences of intraLATA toll versus interLATA markets. BOCs successfully delayed implementation of dialing parity for intraLATA toll markets, where they were allowed to compete. In contrast, establishing the physical and administrative arrangements for equal access to IXCs after divestiture was a considerable achievement for the industry, and it was made possible in large part by BOCs' willingness to cooperate given that they were barred from directly participating in long distance and thus had strong interests in ensuring efficient operation of the exchange access business.

##### **2. Importance of securing BOC cooperation before authorizing entry**

156. As explained previously, relying on penalty threats to force implementation of new systems is problematic, because enforcers will have far less information than the BOC about how long the

process should take. Providing a BOC with incentives to act faster—by authorizing its entry only once sufficient implementation has occurred—will accomplish the process more quickly and more efficiently. Once these main new technical and organizational access arrangements for local competition are in place and shown to be working, they can establish performance benchmarks to assist enforcers in preventing future backsliding. That is, pre-entry implementation of the new systems makes regulatory and other safeguards considerably more effective and less burdensome

157. On the other hand, once entry is authorized, BOC incentives to continue cooperating will diminish significantly. As a practical matter, rescinding a BOC's long-distance authority would be difficult and, in any event, would be disruptive. While freezing a BOC's future marketing authority would be a more practical option, it also is less potent. Faced with a loss of an important incentive mechanism—the § 271 entry authority—BOC cooperation would have to be induced by threatening penalties which, as noted, are less effective when the issue is implementation of new measures. Thus, it is important to grant BOC entry only after sufficient cooperation has first been secured

### **3. The benefits from delayed BOC entry outweigh the costs**

158. The Department of Justice's standard would involve some delay in BOC entry relative to adopting an "early" entry standard that required only checklist compliance on paper. This will impose non-trivial costs, by temporarily depriving consumers of increased availability of integrated services, as well as increased competition in long-distance services (see section II). But the costs of delay are outweighed by the prospective benefits

#### **a. Local versus long-distance markets**

159. A BOC's local markets are about twice as large as its in-region long-distance markets. In addition, the local market is a regulated monopoly, with substantial room for improvement in performance. In contrast long-distance markets, though not perfectly competitive, exhibit considerable rivalry and are becoming more competitive even without BOC entry. The gains from injecting even a modest dose of local competition can thus easily outweigh those from adding one, albeit major, competitor into long-distance markets in a BOC's region. (Recall that BOCs already may offer long-distance service outside their regions.)

160. Aside from its inherent benefits, local competition can also help safeguard long-distance competition in the longer run. A BOC's entry into long distance is likely, over time, to pose a growing threat to the ability of IXCs to compete with it on an equal footing, or invite more intrusive regulation to prevent this, than if local competition emerged sooner. Finally, local competition holds the key to robust competition in offering integrated services—since the key monopolized pieces are local inputs and services

**b. Integrated services**

161. "*Competitive parity.*" The BOCs argue that any delay of their entry into long distance would give their competitors—especially the major IXCs—important and unfair first-mover advantages in competing to provide integrated services (such as offering one-stop shopping). In addition, and somewhat inconsistently, they argue that delaying BOC entry would deny consumers the benefits of these offerings which the BOCs—if allowed into long distance—would be *uniquely* positioned to provide. I address first the issue of competitive parity, then the more important questions of impact on consumers and on overall welfare

162. In general, the competitive process works best when no artificial handicap is placed on competitors and all firms are allowed to compete on the merits. At first glance, delaying BOC entry while IXCs and others make inroads into local markets may seem to violate this principle of respecting competitive parity in offering integrated services. This, however, overlooks the fundamental asymmetry in the position of a BOC versus other players

163. The BOC is the sole major source of local services in its region. In contrast, there are several national and many regional facilities-based providers of long-distance services. If reciprocal entry is allowed concurrently—that is, if BOC entry into long distance is allowed immediately—the BOCs will have a major and artificial advantage in offering integrated services. They will be able to obtain long-distance services rapidly, seamlessly, and at prices very close to cost—because of the vigorous competition among IXCs vying to sell such services to a large wholesale customer as the BOC. In contrast, other would-be providers of integrated services have only one major source for local services—the BOC. Once allowed into long distance, a BOC would have strong incentives to deny to others the various wholesale local services they need to offer integrated services. Potential

competitors would have to wrangle with this sole provider for every new access arrangement or discount. Regulatory and antitrust intervention can certainly help, but it cannot in a cost-effective manner eliminate entirely the disadvantage resulting from the absence of local competition, if it could, we would rely on regulation and not insist on competition

164 Moving towards parity in competition for integrated services therefore calls for insisting that the BOCs first take substantial measures to open up their local markets—even if by doing so they expose themselves to some entry—because once they are allowed into long distance they can rapidly make up any advantage the IXCs might have temporarily gained.<sup>59</sup>

165 *Effect on consumers.* More important than the effect on competitive parity for its own sake, is the effect delayed BOC entry has on consumers of integrated services and on overall welfare. Delaying BOC entry would delay delivering the benefits of integrated services to consumers through the BOC. However, integrated services will be available to some extent from non-BOC sources. Competitors other than the largest three IXCs could attempt to obtain BOC local services for total service resale. And all competitors could attempt to provide their own local services through facilities-based entry or through use of unbundled local elements leased from the BOC.<sup>60</sup>

166 Admittedly, competitors are unlikely to obtain such local inputs or services as efficiently and expeditiously as the BOC would have offered its own long-distance affiliate. It will take time and regulatory pressure to implement the necessary new arrangements for supplying competitors with

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<sup>59</sup> The structure of the Act reflects a desire to prevent either the BOCs or the IXCs from gaining a substantial "first mover" advantage in offering packages of local and long-distance services, and does so by attempting to deny either one a significant head start. Thus, § 271 requires the opening of the local market to competition—for both resale and unbundled element competition—before BOCs may enter the long-distance market. Similarly, § 271(e) prohibits large IXCs from jointly marketing resold local services in a state prior to the BOC's long-distance entry and, except where already required by a state, limits the implementation of intraLATA toll dialing parity prior to the BOC's entry. Finally, the Act requires the FCC to act on § 271 applications within 90 days, a requirement that ensures that BOC entry will occur promptly after—but not before—all prerequisites for such entry have been satisfied. I believe these requirements are consistent with the above reasoning.

<sup>60</sup> Although the Act prohibits the three largest IXCs from jointly marketing long-distance services with local services obtained from the BOC for total service resale, until BOC interLATA entry is authorized (or until February 1999), it allows joint marketing of local services provided via one's own facilities or via unbundled BOC elements.

wholesale local services. Quite aside from BOC reluctance, there may be genuine transaction costs in making local inputs available to others as smoothly as to one's own affiliate, transaction costs often explain why in many settings firms prefer vertical integration over arm's length contracting with others. Thus, the local components of integrated services available from non-BOC suppliers are likely to be inferior to or not available as promptly as those that would be available from a BOC if it were immediately allowed to offer long-distance and thus integrated services. This inferiority will show up in the price or quality of the integrated services offered to consumers by non-BOC providers

167. However—and this is the rub—the BOC will more willingly supply to others its local services or inputs and on better terms if it is barred from long-distance and thus integrated services. As explained earlier, a BOC's incentives to promote such wholesale products increases if it is barred from selling, especially at unregulated prices, competing retail services

168. In short, barring a BOC from long distance creates a tradeoff regarding integrated services. No other competitor is likely to have as good a set of local services as quickly as would a BOC if allowed immediate interLATA entry. But while a BOC is barred from offering retail integrated services, it has incentives to supply others with wholesale local services on better terms than after it secures interLATA entry. This availability of "better" local inputs to a broader set of players is valuable; additional players bring greater variety and other benefits (improved customer service, more experimentation with new pricing plans, and other creative offerings). The net effect of earlier BOC entry on market performance in delivering integrated services is thus theoretically ambiguous in the short run. In the long run, competition in integrated services is likely to be far more robust and performance thus superior if strong local competition emerges. That goal is better advanced by authorizing BOC entry only after the conditions of the Department's standards have been met.

169. For all these reasons, accepting a modest delay in BOC entry to comply with the Department's standard is a worthwhile price. BOC cooperation in implementing the § 271 competitive checklist requirements would go a long way towards laying the foundation for healthy local competition. And securing such cooperation is far more likely by making it a prerequisite for BOC interLATA entry. Accepting a modest delay of BOC entry does not foreclose future options, but once entry authority is granted, we may have lost an important tool for opening the local market

### C. Local Competition as Evidence of an Open Market

170 Seeing significant and diverse local competition take root provides by far the best evidence that the market indeed has been irreversibly opened to competition. On the other hand, even with an open market, local competition may still be delayed for other reasons.<sup>61</sup> In particular, we should not expect to see all forms of local competition in all locations, and certainly not right away; indeed, the guiding philosophy of the Act is that market forces should be allowed to dictate what works and what doesn't, once artificial barriers have been removed. For example, if we are successful in ensuring that incumbents make available unbundled network elements at prices reasonably close to incremental cost and if such arrangements work smoothly, then it would be wasteful to insist that entrants build entirely their own facilities.

171 Balancing these two considerations, I see the role of observing local competition as establishing presumptions: if sufficient competition is observed, the market is presumed open. If not, one should ask why not, the BOC would face a heavier burden to demonstrate that the market is truly open and that the absence of actual competition was not for lack of BOC cooperation in opening up its networks to competitors.

172 The best proof is in the pudding: the emergence of local competition provides by far the best evidence and assurance that the local market indeed has been irreversibly opened. Observing local competition is helpful for several reasons:

173 *Checklist implementation* Seeing some actual competition is the most convincing demonstration of meaningful checklist implementation. Without seeing new access arrangements in use by competitors, there will be lingering doubt as to whether these arrangements are truly adequate or whether their pricing is appropriate to make entry by efficient competitors feasible.

174. *Signal of entrants' confidence* Competitors' willingness to commit significant irreversible investments to the market (sunk costs) signals their perception that the requisite cooperation from incumbents has been secured or that any future difficulties are manageable. Since competitors are

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<sup>61</sup> For instance, some potential entrants are re-evaluating plans to build their own loops and waiting for technological advances that would allow broad-band delivery capability and let them offer not only telephone service but also video and data services.

knowledgeable about the industry and have an obvious stake in making competition work, their actions speak loudly.<sup>62</sup> Indeed, firm plans to commit substantial investments to the market could be a better indicator than observing a more limited amount of competition already in place. (It is important, however, that the plans be firm, e.g., involving contracts for specialized equipment that entail substantial penalty clauses for cancellation. There is a long record of plans to enter local phone service that have been perennially revised, such as by the cable companies to cite one example.)

175. *Entrants' direct role in safeguarding competition* Quite aside from signaling confidence that local competition can be successful, the presence of competitors can directly help to prevent backsliding on cooperation by incumbents. The presence of competitors can provide regulators with additional benchmarks of what is possible and at what cost, thereby helping regulators (or the courts) to better enforce incumbent cooperation. In addition, established competitors create an additional constituency with a stake in preventing backsliding by incumbents or regulators. Once established competitors are in place, they can help to limit discrimination by acting as whistle blowers.

176. In all cases, of course, the more widespread is the local competition geographically, in the types of services offered, and in the range of access services used from the incumbent, the greater is our degree of confidence that the market has been opened.

177. *Resale versus other entry modes.* It is important to ensure that facilities-based entry options (including through unbundled elements) are truly made possible, as they have important potential advantages over total service resale. They can discipline an incumbent's behavior in more segments, not only on the retailing side but also in certain network functions, for example, entrants renting unbundled loops but bringing their own switches can help curb switch-based discrimination against long-distance carriers in securing local access, and can allow the introduction of new services based on the electronic features in the switch.

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<sup>62</sup> In general, it is instructive to observe the actions of parties that have a direct interest in the outcome, because they are likely to have better information than outsiders or find it in their incentives to obtain such information. This principle of "follow the money" has led economists to place substantial weight on how the stock market interprets various events.

178. In addition, entry using unbundled elements can often exert stronger downward pressure on retail prices than can entry through resale—partly due to the different pricing standards adopted in the Act: wholesale prices for total service resale are computed “top down,” by starting with retail prices and subtracting only the avoided retailing costs; in contrast, unbundled elements are priced “bottom up,” by starting with the estimated facility costs of these elements. Since retail prices for many services are well above the underlying costs of both retailing and network elements, subtracting only the estimated retailing costs to obtain wholesale prices for total service resale is likely to still leave these wholesale prices above the underlying costs of facilities.

#### **D. Assessing Local-Market Openness in the Absence of Sufficient Competition**

179. As mentioned, we do not expect to see all forms of competition everywhere. However, if sufficiently diverse competition is not observed, it is important to understand why. Before concluding that this is simply for lack of interest by entrants in pursuing certain entry modes in certain regions, it is important to ascertain that competition is not being stifled by artificial barriers. Indeed, absent a showing by the BOCs that lack of entry simply reflects a lack of interest, the presumption should be that the market is not open. Reversing this presumption requires verifying that the main elements of an open market indeed are in place. The main elements are discussed below.

##### **1. Full, meaningful implementation of new access arrangements**

180. Many of the access arrangements required by the Act for local competition are new. They raise a host of novel issues in technical areas (e.g., loop unbundling), business protocols (e.g., for switching customers from the incumbent to entrants under total service resale), and sharing operations support systems. A condition for finding the local market open, when sufficiently diverse local competition is not yet observed, should be that all such major systems and protocols (including but not limited to loop unbundling, electronic interfaces, operations support systems, access to signaling and databases) are readily available for commercial usage. They should provide regulators sufficient confidence that the conditions have been established to facilitate efficient entry through all three entry modes contemplated in the Act (facilities based, unbundled network elements, and resale), and for serving all major types of customers. And they should provide a sufficient track record of performance to give regulators reliable benchmarks for gauging and enforcing future cooperation.

181. Moreover, the scale of operations is critical. Systems that stringently cap the rate at which the incumbent's customers can switch to competitors, for example, by processing orders manually or having only a few and perennially busy fax machines, are a sure way to stifle competition. In order not to significantly impede competitors' ability to expand, the above systems should also be capable of being scaled up relatively quickly to accommodate reasonably foreseeable expansion demanded by entrants in a given geographic region (e.g., the ability to rapidly switch over to the entrant a large number of customers, through loop unbundling or total service resale), and capable of being rapidly extended to regions where they are not initially implemented. In addition, a BOC must have implemented number portability and local dialing parity.

182. These new access arrangements must be proven to work in practice. Many of the arrangements called for by the Act (such as loop unbundling) are unprecedented. Implementing such radical new arrangements often proves more difficult than expected even where there is goodwill on both sides.<sup>63</sup> These difficulties increase by an order of magnitude, however, when one side is recalcitrant, there is then endless scope for acrimony and mutual finger pointing, creating a regulatory morass. It is therefore important to have some practical experience with these arrangements, under real-world business conditions and not just in the laboratory, and iron out the major kinks while incumbents are still relatively predisposed to cooperate. The absence of (non-trivial) competition calls for waiting longer to test the new access arrangements, because experience with them under competitive conditions could help pinpoint potential problems more quickly. One should conclude that the market is open only if there is sufficient confidence that the major implementation problems have been resolved.<sup>64</sup>

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<sup>63</sup> For example, I learned from Bell Atlantic in July 1996 that it had been working with MFS in Baltimore since February 1995 to implement loop unbundling and had encountered considerable difficulties despite both parties' attempts to work cooperatively.

<sup>64</sup> Indeed, the arbitration process has not addressed all the relevant issues. (1) Many states have yet to establish performance standards and in certain cases have been reluctant to involve themselves at all in private negotiations on such matters despite appeals by entrants to do so. (2) Some states have determined that certain issues (such as liquidated damages), were outside their jurisdictional boundaries, wholly precluding their consideration in arbitration. Thus, insistence on appropriate performance benchmarks through the § 271 process can usefully complement state efforts.

## 2. Cost-based pricing of new local-competition access arrangements

183. "Availability" of the above access arrangements will be illusory if prices are prohibitively high. Thus, interconnection agreements forming the basis for § 271 entry authority under Track A, or interconnection offers under Track B, should provide entrants with satisfactory pricing assurances. Prices should be reasonably close to cost, as stipulated in the Act. And competitors must have adequate assurance that prices will remain reasonable and cost-based after interLATA relief is granted, in order to make efficient entry viable. Thus, if interim prices are used in the BOC's agreements or offers, there should be some assurance that after interLATA entry is authorized the BOC's prices to local competitors will remain within a tolerable range of these interim levels (e.g., indexed to inflation plus or minus a modest deviation) for a sufficient duration.

184. Even entrants building their own networks will require reasonable prices for terminating their calls on the incumbent's network, assuring such prices is thus critical to the development of facilities-based local competition. Reasonable prices also are necessary for unbundled network elements if, as Congress intended, we are to facilitate also partial facilities-based competition, it would be tremendously costly, slow, and often inefficient for entrants to duplicate the incumbent's entire local network, especially its local loop. Finally, reasonably-priced local service for total service resale is needed in order to provide other carriers a meaningful opportunity to compete quickly and widely in providing integrated services.

185. *Pricing standards.* Section 252 (d) of the Act requires state commissions to use the following pricing standards in arbitrating disputes between incumbents and local competitors: (1) prices of interconnection and unbundled network elements should be based on each party's cost of providing these items, (2) prices of transport and termination of local calls should provide for mutual and reciprocal recovery by each carrier of (a reasonable approximation of) the additional costs of terminating such calls, and (3) wholesale prices should be based on retail prices for these services minus the marketing, billing and other costs that will be avoided by the LEC by selling at wholesale versus at retail.

186. The FCC in its Local Competition Order, while acknowledging that responsibility for arbitrating specific price levels rests with state commissions, proposed a methodology for arriving at

prices: (1) for interconnection and unbundled elements, use forward looking Total Element Long-Run Incremental Cost (TELRIC); and (2) for transport and termination, require symmetric prices based on the incumbent LEC's TELRIC. It suggested proxy ranges for these prices, and for wholesale discounts for total service resale, that a state commissions could use pending completion of its own cost study. These pricing rules and interim proxies were generally praised by competitors, but have been stayed by the Eighth Circuit. Considerable uncertainty remains about the course of these key prices.

187 *Role of § 271 entry authority.* Denying BOC interLATA entry when local competition is seriously impeded by inappropriate BOC pricing of key local inputs can accelerate opening of the local market. Although state commissions are empowered to arbitrate pricing disputes between incumbents and competitors, awareness that the § 271 process will weigh seriously whether key inputs are priced in a manner that supports efficient local entry will usefully complement state efforts to enforce procompetitively low input prices by the BOC to competitors in order to open the local market. This point merits elaboration.

188 State arbitration of interconnection agreements does not occur in a political vacuum. Rather, prices emerging from arbitration are likely to reflect the demands and bargaining powers of the incumbent and its potential competitors. There is great asymmetry in these bargaining powers—since the dominant incumbent is content to preserve the status quo, while the entrant is clamoring for an agreement. By making procompetitive BOC prices to local competitors a requirement for finding the local market to be open one can help reduce the bargaining-power asymmetry, and thus reduce the BOC's prices—thereby complementing state efforts to foster local competition.

### 3. Removal of substantial regulatory and other barriers

189 Finally, in order to be confident that the local market is irreversibly open, one must ascertain that there remain no major state regulatory or other artificial barriers likely to significantly delay local competition. The Act requires removal of such barriers,<sup>65</sup> but there are gray areas. States have some

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<sup>65</sup> Section 253(a) states: "No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." Section 253(d) empowers the FCC to preempt such barriers.

latitude to impose obligations under the rubric of protecting universal service, local authorities may manage public rights-of-way or require fair and reasonable compensation for their use. Although all such actions must be on a competitively neutral and nondiscriminatory basis, there is sure to be controversy over the precise meaning of these terms.<sup>66</sup> Thus, the timeliness and effectiveness of FCC preemption of such barriers is uncertain. In addition, the BOCs themselves may have latitude to engage in certain practices which, while not explicitly unlawful, may hinder competition.<sup>67</sup>

190. If such barriers are likely to seriously delay competitors' ability to avail themselves of new technical and pricing arrangements for access put in place with BOC cooperation, these arrangements could become obsolete. The value of BOC cooperation in establishing these arrangements will then decay, and securing BOC cooperation again in establishing new arrangements once these barriers have been removed but after BOC entry has been authorized will be far harder.<sup>68</sup>

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<sup>66</sup> For example, Texas has imposed certain "buildout" requirements on entrants, requiring them to provide service over at least a certain area which may hamper their ability to enter effectively; requests are pending with the FCC to preempt this and other provisions of the Texas statute. Numerous municipalities reportedly plan to impose fees on new telecommunications providers—but not on incumbents—for use of rights-of-way and local infrastructure. Bryan Gruley, "Disputed Call: Detroit Suburb Sparks Fight by Levying Fees on Telecom Concerns," *Wall Street Journal*, December 23, 1996. The FCC has decided not to challenge such fees in the case of Troy, Michigan.

<sup>67</sup> For example, some incumbent LECs are said to be signing exclusive access agreements with landlords of multi-unit buildings, housing a high density of customers. Such agreements could stifle the ability of entrants to compete, by denying them the opportunity to attain economies of density in a given area. A provision prohibiting such agreements was dropped from the Act, nevertheless, permitting such agreements can hinder competition.

<sup>68</sup> A concern is that a standard which links BOC entry to removal of regulatory barriers beyond its influence may discourage BOC cooperation, because cooperation may fail to yield a reward. There are several responses to this concern however. First, a BOC's ability to influence the regulatory process in a state should not be underestimated. Second, requiring an open market as a condition for BOC entry can help persuade states to do more to remove remaining barriers. Third, and most importantly, dismantling such barriers need not impose onerous delay; whereas authorizing BOC entry before the local market is open can seriously jeopardize prospects for opening it in the future. The reasons are twofold: (a) Such barriers may prevent commercial use by entrants of the BOCs' wholesale inputs and prevent the BOC from demonstrating that their systems will work under actual usage. (b) As noted in the text, even if the systems would work today, these systems could require major changes if sufficient time elapses before entry. Thus, if entrants cannot avail themselves of these new systems for some time due to the presence of residual barriers, the initial BOC cooperation in establishing these new systems will have had only limited value, and securing future BOC cooperation in updating these systems once these barriers have been removed will be more difficult if BOC entry has already been authorized. As a practical matter, however, I believe that meaningful BOC implementation of the competitive checklist is likely to result in opening the local market in most cases.

**E. Conclusion: The Department of Justice's Entry Standard Is Procompetitive**

191. The major remaining bottleneck in telecommunications today, controlled by the BOCs in most regions, is local networks. These regulated local monopolies are an inefficient institution, whose replacement by a mix of local competition and lighter regulation can generate large net social benefits in local services, in integrated services, and in protecting and promoting competition in long-distance services while allowing BOC entry. This is the guiding philosophy of the 1996 Act.

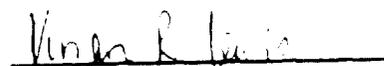
192. Authorizing BOC entry when—and only when—the BOC's local market is open would go a long way to promoting local competition and achieving the goals of the Act. The Department of Justice's entry standard embodies this principle. It strikes a good balance between attempting to rapidly realize the benefits from BOC entry while properly addressing the competitive concerns, and therefore serves the public interest in competition.

I hereby swear, under penalty of perjury, that the foregoing is true to the best of my knowledge and belief



Marius Schwartz

Subscribed and sworn before me this 15<sup>th</sup> day of May, 1997.



Notary Public

My Commission Expires March 31, 2001