



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

In the Matter of Applications for Consent)	
to the Transfer of Control of Licenses and)	
Section 214 Authorizations from GTE)	CC Docket No. 98-184
Corporation, Transferor, to Bell Atlantic)	
Corporation Communications Inc., Transferee)	

DECLARATION OF KENNETH C. BASEMAN AND A. DANIEL KELLEY

I. INTRODUCTION

1. MCI WORLDCOM, Inc. (“MCI WorldCom”) has asked us to prepare this economic analysis of issues raised by the proposed merger between GTE Corporation (“GTE”) and Bell Atlantic Corporation (“Bell Atlantic”).

2. Kenneth Baseman is a Principal with MicRA, an economic consulting firm in Washington, D.C. He received his graduate training in economics at Stanford University. He served as a senior economist in the Economic Policy Office of the Antitrust Division of the Department of Justice where, for over two years, he was a member of the Division’s trial staff in U.S. v. AT&T. He has been an economic consultant for thirteen years. His consulting assignments have focused primarily on competitive issues, both in antitrust and regulatory proceedings. His earlier professional papers dealt with entry and competition in a regulated

industry with natural monopoly characteristics and were published in the *American Economic Review*, and by the National Bureau of Economic Research and the MIT Press. His more recent publications have focused on the use of non-linear pricing and technical incompatibility by dominant firms to preserve market power in the face of developing competition. He has consulted on telecommunications issues with the Department of Justice, MCI, AT&T, the National Cable Television Association, and WebCel Communications, and he has testified on competitive issues relating to telephony before state commissions in Ohio, Wisconsin, Texas, Georgia and Kansas. A copy of his vita is attached to this Declaration.

3. Daniel Kelley is Senior Vice President of HAI Consulting, Inc. ("HAI"), of Boulder Colorado. He received a Bachelor of Arts degree in Economics from the University of Colorado in 1969, a Master of Arts degree in Economics from the University of Oregon in 1971 and a Ph.D. in Economics from the University of Oregon in 1976. His professional experience began in 1972 at the Antitrust Division of the U.S. Department of Justice where he analyzed mergers, acquisitions and business practices in a number of industries, including telecommunications. While at the Department of Justice, he was a member of the U.S. v. AT&T economics staff. In 1979, he moved to the Federal Communications Commission ("FCC") where he held positions as Senior Economist in the Common Carrier Bureau and the Office of Plans and Policy, and also served as Special Assistant to the Chairman. After leaving the FCC, he was a Project Manager and Senior Economist at ICF, Incorporated, a public policy consulting firm. From September 1984 through July of 1990, he was employed by MCI Communications Corporation as its Director of Regulatory Policy. He conducts economic and policy studies on a wide variety of

telecommunications issues, including local exchange competition, dominant firm regulation, and the cost of local service. He has advised foreign government officials on telecommunications policy matters and has taught seminars in regulatory economics in a number of countries. He has testified on telecommunications issues before this Commission, the California, Colorado, Connecticut, Florida, Georgia, Hawaii, Maryland, Massachusetts, Michigan, New York, Oregon, Pennsylvania and Utah Commissions, as well as the Federal-State Joint Board investigating universal service reform. His resume is attached.

4. We recently prepared a Declaration for MCI WorldCom analyzing the anti-competitive effects of the SBC-Ameritech merger.^{1/} The Bell Atlantic-GTE merger obviously raises similar issues. Therefore, we relied heavily upon our previous work in connection with the earlier Affidavit in preparation of this analysis. An important difference between the analysis of the SBC-Ameritech merger and this one is that GTE currently provides interLATA telecommunications services in Bell Atlantic's region that Bell Atlantic cannot provide directly or through an affiliate under the terms of Section 271.^{2/} Also of importance is the fact that GTE is a major player in the Internet and has a major presence in Bell Atlantic's territory through GTE Internetworking. Finally, both GTE and Bell Atlantic own operating telephone companies

^{1/} Affidavit of Kenneth Baseman and A. Daniel Kelley, *In the Matter of Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from Ameritech, Corporation, Transferor, to SBC Communications Inc., Transferee*, CC Docket No. 98-141, submitted October 15, 1998.

^{2/} Section 271 was added to the Communications Act by the Telecommunications Act of 1996, Pub.L. No. 104-104, 110 Stat. 56 ("1996 Act").

in Pennsylvania and Virginia. Bell Atlantic and GTE argue that GTE's service "islands" can be used as launching pads for out-of-region entry.

5. As was the case with the SBC-Ameritech merger, we conclude that the consolidation of GTE and Bell Atlantic raises substantial competitive risks without countervailing public interest benefits. We note that this merger raises substantial competitive risks even if the SBC-Ameritech merger is not approved.

6. In approving the acquisition of NYNEX by Bell Atlantic, the Commission found that there were substantial anticompetitive effects flowing from the merger.^{3/} The Commission concluded that the merger could be approved only if Bell Atlantic took a number of steps to open its local markets to competition.^{4/} We understand that Bell Atlantic has not honored the commitments that it made during the BA-NYNEX proceeding.^{5/} Now, like SBC and Ameritech before them, GTE and Bell Atlantic attempt to justify their merger with a plan to enter local

^{3/} *In the Matter of the Application of NYNEX Corporation and Bell Atlantic Corporation for Consent to Transfer Control of NYNEX Corporation and its Subsidiaries*, File No. NSD-L-96-10, released August 14, 1997. ("BA-NYNEX Order")

^{4/} The merger conditions agreed to by Bell Atlantic include agreeing to accept TELRIC as the mechanism for pricing unbundled network elements, preparation of service monitoring reports, uniform interfaces to Operations Support Systems ("OSS"), operational testing of interfaces, options for payment of non-recurring charges, a shared transport unbundled network element, as well as performance standards and enforcement mechanisms. See BA-NYNEX Order, Appendix C.

^{5/} See Complaint of MCI Telecommunications Corporation and MCIMetro Access Transmission Services, Inc., File No. E-98-12 (filed December 19, 1997) and Complaint of MCI Telecommunications Corporation and MCIMetro Access Transmission Services, Inc., File No. E-98-32 (filed March 17, 1998) for descriptions of how Bell Atlantic has failed to comply with the pricing and performance standards conditions it agreed to.

markets outside their regions. From an economic perspective, there is no reason to believe that Bell Atlantic-GTE will have any more incentive to enter markets outside their territories than they would have as separate entities.

7. By claiming that a merger between two of the largest telephone companies in the world is required to enable entry into local markets not already served by them, Bell Atlantic and GTE concede that entry into local markets is extremely difficult. GTE has had longstanding plans to enter into adjacent markets,^{6/} but now implicitly admits that its fellow incumbent local exchange carriers (“ILECs”) have failed to open their markets sufficiently to allow such entry when it argues that “economical local entry requires truly proximate facilities.”^{7/}

8. This market environment leads to the following major conclusions. First, as the Commission found in the BA-NYNEX Order, there are only a limited number of firms capable of challenging ILECs for mass market customers. Experience in the past year shows that the prospects for widespread entry in the short term by competitive local exchange carriers (“CLECs”) are actually lower now than they were perceived to be a year ago. Both AT&T and MCI WorldCom have virtually abandoned resale as an entry vehicle because the discount levels set in state arbitrations are too small, ILEC Operations Support Systems for provisioning resold lines do not work, and resale limits the ability of firms to differentiate their services.

^{6/} See Bell Atlantic-GTE, Public Interest Statement, p. 7.

^{7/} *Id.*

9. CLECs continue to be frustrated by the high price of, and difficulty in procuring, unbundled network elements (“UNEs”). AT&T appears to have embarked in a new direction with the proposed acquisition of TCI. Whether cable assets can be used as a basis for entry into mass market telephony remains to be seen, and the result will not be known until at least several years and many billions of dollars are spent. Wireless alternatives are unlikely to fare much better. As a result, *de novo* out of territory entry by an existing ILEC willing to break from the cartel remains a key competitive entry mechanism.

10. ILECs have provided local telephone service for over a century, they own and know how to operate necessary support systems, they are extremely profitable, and judging by their international investments, they have the capital and the ability to invest outside their traditional geographic markets. Moreover, ILECs are uniquely situated to challenge the discriminatory interconnection and pricing policies that are slowing entry by other carriers. State Commissions ruling in arbitration proceedings face a significant information asymmetry problem. An out-of-region ILEC would be an extremely credible participant in an arbitration proceeding. Thus far, no ILEC has entered local markets out-of-region on any significant scale. However, the more ILECs there are, the more likely it is that one of them will break from the cartel.

11. The merger will cause direct competitive harm in several significant ways. First, the merger will eliminate GTE as an independent entrant into local markets in Bell Atlantic’s region, and vice versa. Second, benchmarking ILECs is an important regulatory tool, and one that Bell Operating Companies (“BOCs”) relied upon to justify their requests for eliminating MFJ line of

business restrictions.^{8/} This merger will eliminate a significant benchmark. Third, if BOCs such as Bell Atlantic receive Section 271 authority prematurely, their ability to harm competition is enhanced to the extent their territories are larger. This is because more calls will originate and terminate in their territory, thus increasing the return to discrimination. Finally, the merger places at risk the continued evolution of the Internet on a competitive basis.

12. The potential negative impact on Internet competition is particularly significant. The Internet has developed under a competitive environment, with no single firm dominating its evolution. If this merger is approved, then an even smaller group of firms will dominate the last mile between Internet providers and their customers. If this control over the last mile is leveraged into control over access to and from Internet service providers (“ISPs”), the most technologically vibrant and fastest growing segment of the economy could be damaged.

13. The out-of-region entry proposed by Bell Atlantic-GTE does not compensate for these anticompetitive effects. First, there is no real assurance that this “commitment” is any more credible than the BA-NYNEX “commitment” to open their markets.^{9/} Second, the primary Bell

^{8/} Benchmarking is the process by which direct comparison of firms is used to evaluate conduct and performance. Both regulators and customers can use benchmarking to their advantage.

^{9/} We would note that Bell Atlantic is still doling out commitments in hoped for exchange of regulatory favors. See *In the matter of Petition of New York Telephone Company for Approval of its Statement of Generally Available Terms and Conditions Pursuant to Section 252 of the Telecommunications Act of 1996 and Draft Filing of Petition for InterLATA Entry Pursuant to Section 271 of the Telecommunications Act of 1996*, Pre-filing Statement of Bell Atlantic New York, Case 97-C-021 (New York Public Service Commission, April 6, 1998) (A copy of Bell Atlantic’s filing is available at <http://www.dps.state.ny.us>). Instead of actually

Atlantic-GTE strategy is to provide facilities based competition in competition with the existing CLECS. Competition for the business of major corporate customers in central business districts is further advanced than mass market competition, at least as measured by installed capacity, but is still very limited.^{10/} There is no reason to believe that a combined Bell Atlantic-GTE would be any more able to serve mass markets outside their territories than existing CLECS, including AT&T and MCI WorldCom.

14. GTE and Bell Atlantic argue that there are other public interest benefits that will flow from the merger, including realization of economies of scale and greater competition in the long distance market. GTE and Bell Atlantic are already very large carriers and have likely exhausted all available scale economies.^{11/}

opening local markets to competition, the 1996 Act merely opened up an extending bargaining session between CLECs and ILECs, with ILECs still holding most of the chips and the CLECs relying on regulatory intervention to enforce the Act.

^{10/} See, e.g., Jonathan Kraushauer, Fiber Deployment Update, End of Year 1997, Common Carrier Bureau, FCC. pp. 34-35 for a description of CLEC fiber investments. In the Order approving the SBC-SNET merger, the Commission found that “. . . incumbent LECs are facing increasing competition in these business markets, and numerous new entrants are rapidly entering this market, especially in central business districts in urban areas.” *In the Matter of Application for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from Southern New England Telecommunications Corporation, Transferor to SBC Communications, Inc., Transferee*, CC Docket No. 98-25, released October 23, 1998, para. 20 (“SBC-SNET Merger Order”).

^{11/} Cost data collected by the Commission fail to support the view that there are significant scale economies in providing local telecommunications services — at least for firms as large as the BOCs. In 1997, Southwestern Bell and Bell Atlantic showed higher overall expenses per line than Ameritech, US West and BellSouth. (Based on data in Common Carrier Statistics, 1997.)

15. Section II below discusses the evolving structure of the local exchange business. Section III discusses the loss of benchmark and likely competitive harms in the long distance market that will be caused by the merger. Section IV addresses the supposed major public interest benefit of the merger — out of region entry by the combined Bell Atlantic-GTE. With this background, the effect of the merger on local markets is also discussed in Section IV. Section V addresses the impact of merger on broadband competition and the Internet. Section VI shows that Dr. Thomas Hazlitt's stock market event analysis, purporting to show that the merger will be procompetitive, is flawed. A more sophisticated event analysis produces the opposite conclusion. The summary and conclusions are in Section VII.

II. POST MERGER INDUSTRY STRUCTURE

16. This Section discusses developments in local competition and the nationwide structure of the local service business. Section A shows that competition for the business of large customers is beginning, but mass market competition has yet to get off the ground. Section B describes the evolving structure of the local exchange business, demonstrating that if all planned mergers are allowed, the nationwide structure of the local exchange industry will be heavily concentrated.

A. Local Markets Are Not Competitive

17. Although the ILECs have been predicting that local competition is “just around the corner” for more than a decade, the reality is quite different. The high expectations for the development of competition at the time of the passage of the 1996 Act have not been realized.

Demonstrating that the local exchange is still a monopoly, and is likely to remain so for the foreseeable future, does not require an extensive *de novo* antitrust market analysis. The Commission concluded such an analysis just over a year ago when it approved the Bell Atlantic-NYNEX merger with conditions. In the Bell Atlantic-NYNEX Order, the Commission concluded that in New York City LATA 132, arguably the market where local competition is the most developed:

neither the firms remaining in the market nor other telecommunications firms not currently in the market appear able to quickly and effectively increase their presence in response to any exercise of market power in the relevant market.^{12/}

Unfortunately, the commitments made by Bell Atlantic in exchange for approval of the merger have not changed this conclusion.

18. The extensive documentation in the ALTS 706 Petition^{13/} and MCI's May 1998 Access Charge Report^{14/} show that CLECs are still having difficulty procuring essential network elements at reasonable prices. The SBC-Ameritech and Bell Atlantic-GTE merger applications

^{12/} BA-NYNEX Order, para. 143. Also see *In the Matter of Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications to WorldCom, Inc.*, Memorandum Opinion and Order, CC Docket No. 97-211, para. 168, where the Commission found that Bell Atlantic has lost only six percent of the New York Metropolitan area business market to competitors and that "in many other places, the incumbent LEC's market share is or approaches 100 percent."

^{13/} See, *Petition of the Association for Local Telecommunications Services (ALTS) for a Declaratory Ruling Establishing Conditions Necessary to Promote Deployment of Advanced Telecommunications Capability Under Section 706 of the Telecommunications Act of 1996*, CC Docket No. 98-78 (filed May 27, 1998) ("ALTS Petition")

^{14/} See, *ex parte* Letter from Mary L. Brown, MCI, to Richard Metzger, FCC, *In the Matter of Access Charge Reform*, CC Docket No. 96-262, RM 9210, May 7, 1998, p. 27, fn. 59. ("MCI Access Report").

are themselves concessions that entry by means of resale or use of unbundled network elements is extremely difficult. As a result, the ILECs retain substantial market share and monopoly control over the local exchange.

19. The conclusion that ILECs retain monopoly control over the local exchange is also consistent with empirical analysis by HAI. In *The Enduring Local Bottleneck II* (“ELB II”), HAI analyzed the business case for competition for residential and small business customers from cable and wireless operators.^{15/} ELB II concluded that widespread deployment of the competitive technologies is not likely in the near term.^{16/} ELB II analyzed the business case for providing cable telephony over hybrid fiber coax (“HFC”) networks. There have been no changes in technology or costs sufficiently dramatic to change the results of that analysis. Cable companies have been attempting since the beginning of the 1990s to provide telephony over the HFC with virtually no penetration of the residential and small business marketplace.

20. ELB II noted the potential development of cable modem service as an entry point for cable provision of cable telephony services. Developments with Internet voice technology and the recent announcement of the acquisition of TCI by AT&T provide some hope that this technology will help break the bottleneck. However, even assuming that Internet voice will be a reasonably priced and high quality substitute for ILEC circuit switched services, billions of

^{15/} “The Enduring Local Bottleneck II,” Hatfield Associates, Inc., April 30.

^{16/} *Id.* p. 73.

dollars in investment and a substantial amount of time are required to implement this strategy.^{17/} Internet telephony quality problems are likely to be solved in time, but cable companies must upgrade their networks, install the necessary electronics, and market the service (together with a substantial investment in premises hardware) to consumers. As a result, it will likely be some time before that service is widely available. Even if the service becomes widely available, the result will not be a competitive market structure. The structure will be a duopoly with substantial barriers to additional entry.

21. Wireless competition presents similar problems. Fixed wireless solutions may well provide competition for local exchange service in rural areas. However, ELB II concluded that the traffic loads imposed by fixed service make wireless technology impractical as a substitute for local exchange service in more densely populated areas. Broadband wireless also faces significant hurdles before it can become a serious contender for fixed wireline service in the foreseeable future. Although the technology exists, it suffers from coverage problems due to signal attenuation and the need to provide a line of sight connection to customers. It is certainly far from clear now that broadband wireless will overcome these problems.

22. It is also useful to assess local exchange competitiveness with the traditional industrial organization tool of structure, conduct and performance analysis.^{18/} The CLECs are growing

^{17/} See Mike Mills, "AT&T: No Changes in TCI Deal," Washington Post, July 8, 1998, p. C11 .

^{18/} F.M. Scherer and David Ross, *Industrial Market Structure and Economic Performance* (1990). The U.S. Department of Justice *Merger Guidelines* are based on this paradigm.

rapidly. However, today, CLECs primarily provide services for large businesses and IXCs in mostly business sections of large cities. As a result, they often report their progress in terms of markets or cities served. CLEC market penetration gains are also usefully measured on a building-by-building basis. In 1997, CLECs had only 15,667 buildings located on their networks, representing less than 0.31 percent of commercial buildings, and less than 0.012 percent of households and commercial buildings.^{19/} In terms of total national market penetration, the CLECs are today approximately where the competitive long distance providers were twenty years ago when they received authority to provide switched services. They are providing some dedicated services, and are only in the early stages of providing switched services. The percentage of residential and small business customers served by competitors is, of course, even smaller. That number likely rounds to zero percent.

23. MCI WorldCom recently provided the Commission with data on the extent to which it is able to use competitive alternatives to avoid excessive ILEC access charges. An Affidavit filed by MCI WorldCom's Vice President of Network Financial Operations reported that "during the first six months of 1998, an average of only 3 percent of MCI's total billed access charges, and far less than one percent of MCI's switched access minutes, are with competitive access providers ("CAPs") or CLECs."^{20/} This is despite the fact that MCI WorldCom is highly

^{19/} See, MCI Access Report, p. 27, fn. 59.

^{20/} Affidavit of Wayne Rehberger, filed with Comments of MCI WorldCom, *In the Matter of Access Charge Reform*, CC Docket No. 96-262, October 26, 1998. ("MCI Access Charge Reform Comments")

motivated to avoid excessive ILEC access charges and has invested billions of dollars in the means to do it.

24. Viewing the market from the perspective of conduct and performance confirms that the monopoly structure leads to monopoly results. Unlike customers and suppliers in competitive markets, access providers and their long distance customers frequently find themselves in adversarial relationships. For example, ILECs seldom cooperate with their CLEC or IXC customers when requests are made for new or more efficient forms of interconnection.^{21/} If the ILECs were facing imminent widespread facilities-based competition, they would be more than willing to make unbundled network elements available to firms that would otherwise construct competing facilities.

25. The ILECs do not voluntarily reduce prices when their costs fall. Regulators must order reductions. This is demonstrated by the fact that access charges are typically set at the maximums allowed by price cap plans. Productivity adjustments under price cap regimes have been insufficient to prevent the inexorable climb of profits towards full unconstrained monopoly levels.^{22/}

^{21/} The failure of ILECs to cooperate on interconnection issues is detailed in the ALTS Petition and the MCI Access Report.

^{22/} See MCI WorldCom Access Reform Comments for empirical data showing that productivity factors have been inadequate to constrain ILEC prices to competitive levels.

26. ILEC profits dramatically exceed any reasonable estimate of a competitive cost of capital. The most recently prescribed interstate rate of return was 11.25 percent. Reports filed with the Commission show that the price cap carriers are earning 15.52 percent.^{23/} A recent study completed for MCI finds that the ILEC cost of capital is only 9.1 percent.^{24/}

27. The ILECs might argue that this profit performance is due to the fact that price caps provide incentives for cost reductions. It is true that price caps are a contributing factor to the enormous returns. But other factors that may be just as significant as, or more significant than, price caps contribute to the excessive ILEC returns. For instance, access demand is growing due to the per minute access charge reductions the Commission has imposed in the past, and due to competition in the long distance market.^{25/} Costs are falling due to advances in switching and transmission technology that are affecting all high-technology companies.^{26/}

28. In a competitive market, there would be pressure to reduce access charges when profits are as high as those being experienced by ILECs. If competitive firms experienced such

^{23/} *Id.*, p. 31.

^{24/} See Matthew I. Kahal, Analysis of Rate of Return of Local Telephone Companies, submitted with MCI WorldCom Access Reform Comments.

^{25/} Recent per minute access charge reductions ordered by the Commission have been largely offset by increases in per line charges and explicit universal fund assessments.

^{26/} In the BA-NYNEX Order, the Commission noted that “price cap regulation, for example, may not constrain market power” Among the reasons cited by the Commission is the fact that “if carriers offer bundles that contain both price-capped services and some services not subject to price caps but potentially subject to the exercise of market power, the price of the overall bundle is not price capped and market power may be exercised by increasing the overall price of the bundle.” (fn. 201)

decreases in costs and increases in demand, they too might see dramatic increases in profitability, but such levels of profit would be transitory. They would quickly be competed away.

B. From a National Perspective, the Local Exchange Business Is Becoming Heavily Concentrated.

29. Two major ILEC mergers have already been approved by the Commission: SBC-Pacific Telesis and Bell Atlantic-NYNEX. The SBC-SNET merger was also approved recently. As a result, the industry is much more concentrated than it was at the time the 1996 Act was passed. If the remaining announced mergers between SBC and Ameritech and GTE and Bell Atlantic are consummated, concentration will take another dramatic turn upward. Tables I and II compare the concentration among ILECs at the time the 1996 Act was passed and under the hypothetical assumption that all announced mergers are consummated. The change is dramatic. The largest firm will control almost 40 percent of the total revenues and the two largest will control almost 70 percent of the revenues.

Table I					
Pre and Post Merger ILEC Revenue Shares					
1/1/96			1/1/98		
Companies	Revenues	% of Total Revenues	Companies	Revenues	% of Total Revenues
	(000)			(000)	
Bell South	13,900	14.53%	BA Group	38,303	37.14%
Bell Atlantic	12,163	12.72%	SW Bell Group	32,207	31.23%
GTE	12,115	12.67%	Bell South	14,666	14.22%
NYNEX	12,099	12.65%	US West	10,021	9.72%
Ameritech	10,795	11.29%	All Others	7,935	7.69%
US West	9,214	9.63%	Total	103,134	100.00%
Southwestern Bell	8,860	9.26%			
Pacific Bell	7,825	8.18%			
SNET	1,472	1.54%			
All Others	7,198	7.53%			
Total	95,646	100.00%			

Source: FCC, Statistics of Common Carriers, Table 2-9

Table II Pre and Post Merger ILEC Line Shares					
1/1/96			1/1/98		
Companies	Lines (000)	% of Total Lines	Companies	Lines (000)	% of Total Lines
Bell South	22,595	13.61%	BA Group	63,519	32.81%
Ameritech	21,889	13.19%	SW Bell Group	66,878	34.54%
Bell Atlantic	20,705	12.47%	Bell South	25,732	13.29%
Pacific Bell	18,782	11.31%	US West	25,294	13.06%
NYNEX	18,032	10.86%	All Others	12,191	6.30%
US West	17,671	10.64%			
GTE	17,354	10.45%			
Southwestern Bell	16,343	9.84%			
SNET	2,057	1.24%			
All Others	10,580	6.37%			
Total	166,013	100.00%	Total	193,614	100.00%

Source: FCC, Statistics of Common Carriers, Table 2.10

30. According to the GTE and Bell Atlantic logic, only very large ILECs are capable of an effective national expansion program; they say that they are too small standing alone. Tables III and IV provide concentration figures using the BOCs and GTE as the universe. At the time the 1996 Act passed, the largest BOC, BellSouth, controlled only 14.54 percent of the lines and 15.72 percent of the revenue for this collection of firms. If the mergers are consummated, the “Bell Atlantic group” of telephone companies will control about 40 percent of the revenues while the “SBC group” will control 36.86 percent of the lines and 33.8 percent of the revenue. Only four major ILEC players will be left. If SBC-Ameritech and Bell Atlantic-GTE claims about the firm size required for out of region local entry are to be believed, Bell South and US West should not even be on this list because they are too small to compete on a national scale.

Table III "Major ILEC" Revenue Shares					
1/1/96			1/1/98		
Companies	Revenues (000)	% of Total	Companies	Revenues (000)	% of Total
Bell South	13,900	15.72%	BA Group	38,303	40.24%
Bell Atlantic	12,163	13.75%	SW Bell Group	32,207	33.83%
GTE	12,115	13.70%	Bell South	14,666	15.41%
NYNEX	12,099	13.68%	US West	10,021	10.52%
Ameritech	10,795	12.21%			
US West	9,214	10.42%			
Southwestern Bell	8,860	10.02%			
Pacific Bell	7,825	8.85%			
SNET	1,472	1.65%			
Total	88,443	100.00%	Total	95,197	100.00%

Source: FCC, Statistics of Common Carriers

Table IV "Major ILEC" Line Shares					
1/1/96			1/1/98		
Companies	Lines (000)	% of Total	Companies	Lines	% of Total
Bell South	22,595	14.54%	BA Group	63,519	35.01%
Ameritech	21,889	14.08%	SW Bell Group	66,878	36.86%
Bell Atlantic	20,705	13.32%	Bell South	25,732	14.18%
Pacific Bell	18,783	12.08%	US West	25,294	13.94%
NYNEX	18,032	11.60%	Total	159,311	100.00%
US West	17,671	11.37%			
GTE	17,354	11.17%			
Southwestern Bell	16,343	10.51%			
SNET	2,057	1.33%			
Total	155,429	100.00%			

Source: FCC, Statistics of Common Carriers

31. This concentration in nation-wide control is significant for several reasons. First, there would be competitive effects in both the local and long distance markets resulting from increases in nation-wide concentration. Second, competitive benchmarks are an important regulatory tool, the value of which is reduced as large ILECs merge. Third, the universe of potential entrants is

being reduced significantly by the mergers. Finally, the merger has potential negative implications for the large corporate customers discussed in the Bell Atlantic-GTE Application. Thus, the Bell Atlantic-GTE merger raises a fundamental question for the FCC: how much consolidation will the Commission allow among the BOCs and/or major ILECs — including GTE? These problems are discussed in Sections III and IV below.

III. THE BELL ATLANTIC-GTE MERGER IS INCONSISTENT WITH THE PUBLIC INTEREST

32. This section discusses three major reasons why this merger will harm the public interest. First, a potentially valuable potential entrant — one of a dwindling set of firms — will be lost. Second, a valuable regulatory benchmark will be lost. Finally, competition for long distance and bundled local and long distance service will be put at risk.

A. The Merger Will Remove a Valuable Potential Entrant

33. Neither GTE nor Bell Atlantic has entered local markets out of their territory to date in any significant way. However, GTE has publicly announced its intention to enter local markets] and has established a subsidiary to undertake the business.^{27/} Bell Atlantic does not discuss any entry plans it may have made, other than to deny an interest in entering GTE territory within the Bell Atlantic region. Even if Bell Atlantic does not have *current* plans to enter independently, it,

^{27/} See *GTE Annual Report 1997* (Domestic Operations) (“We formed GTE Communications Corporation — which is our competitive local exchange carrier, or CLEC. It will be able to market the full spectrum of GTE services, including local, long-distance, wireless, and data services, without regard to franchise boundaries.”). A complete copy of GTE’s 1997 annual report (Domestic Operations) is available over the Internet at <http://www.gte.com/AboutGTE/annual1997/domestic1.html>.

along with GTE, is among a small group of firms with the requisite skills and capital to enter the mass market segments of the local exchange business. And current market conditions and plans can change. Bell Atlantic's plans for out-of-region local entry could change if it felt the need to respond to successful local entry on a significant scale in its region by MCI WorldCom, AT&T, or any of the CLECs.^{28/} Therefore, both GTE and Bell Atlantic are valuable potential entrants into markets that would still be highly concentrated even if some initial entry were to take place.

34. One of the reasons that large ILECs such as Bell Atlantic and GTE are important potential entrants to the mass market is that the eventual penetration of the mass market will likely require substantial reliance on resale and unbundled network elements. The prices, terms and conditions for these entry modes are established in contentious arbitration hearings in the states. As noted in the introduction, State Commissions ruling in arbitration proceedings face a significant information asymmetry problem. They are faced with competing claims by ILECs and by competitors of the cost and difficulty of provisioning unbundled network elements. An out-of-region ILEC would be an extremely credible participant in these arbitration proceedings.

35. The market for the business of large corporate customers addressed by Bell Atlantic-GTE is discussed in detail in the next section. We would note here that, if Bell Atlantic and GTE are incorrect about the size and scale required to be viable in that market, the number of significant potential entrants will have been reduced by one.

^{28/} The issues surrounding defensive entry of this sort are discussed below at paragraphs 71-73 and 120.

36. We would also note that potential entry merger analysis must be calibrated differently for telecommunications than for other markets. Standard potential entry theory focuses on “most likely” potential entrants. However, standard potential entry analysis typically focuses on unregulated markets where there have been no legal entry barriers, and where the market is not almost completely monopolized. Entry has only been allowed in local telephone markets for a relatively few years. As a result, the dynamic entry process is not well developed. Therefore, the second, third and fourth most likely potential entrants are more important in this market than in other industrial markets.^{29/} This is especially true if, as SBC and Ameritech argued,^{30/} unlikely potential entrants *today* might be transformed into actual entrants in the future as market conditions change. It would be a mistake not to value the potential pro-competitive prospects of significant potential entrants very highly, even if the potential entrants are not planning current entry. The loss of major potential entrants into GTE’s and Bell Atlantic’s territories (i.e., Bell Atlantic and GTE, respectively) with an admitted strong interest in out-of-region local entry would be substantial.

B. An Important Regulatory Benchmark Will Be Lost

37. Regulators and economists have long understood the importance of benchmarks. This fact has also been recognized by the ILECs, as the Commission noted in the Bell Atlantic-

^{29/} The Commission reached this conclusion in the Bell Atlantic-NYNEX Order.

^{30/} See the “defensive entry” discussion below at paragraphs 71-73 and 120.

NYNEX Order.^{31/} While benchmarking has not eliminated discrimination, it has been a useful regulatory tool. As the number of potential benchmarks is reduced, the value of the tool is correspondingly devalued.

38. There are significant differences between the Bell Atlantic and GTE. These differences are potential sources of information for regulators and customers that will be lost if the merger is approved. For example, as the Joint Declaration of Marcel Henry and John Trofimuk submitted with the Comments of MCI WorldCom in this proceeding show, GTE and Bell Atlantic have taken different positions on several critical business issues, including directory assistance data, reciprocal compensation, automated maintenance systems and account team support. Advances in local competition that may otherwise have occurred in the GTE region as a result of using Bell Atlantic as a benchmark are thus placed at risk if GTE is acquired by Bell Atlantic. Similarly, the acquisition will eliminate policy differences between the companies that would place benchmarking pressure on Bell Atlantic from those areas where GTE's policies are more conducive to local entry than Bell Atlantic's. Bell Atlantic's acquisition of GTE will thus reduce the possibility of meaningful benchmark competition.

39. The Rivers Affidavit filed by SBC in the SBC-Ameritech merger proceeding provides an example of the use of benchmarks by ILEC customers. Rivers reports (at page 9)

... that AT&T, our largest wholesale customer, which is familiar with the methods used by all major carriers in providing HiCap lines, preferred Southwestern Bell's HiCap procedures to those used by other companies. . . .

^{31/} Bell Atlantic-NYNEX Order, para. 149.

Consequently, because of AT&T's request, many of those procedures that were superior to those we were previously using have become standard with us. Business customers, interexchange customers, CLECs, wireless carriers, and others who use HiCap service have benefitted from our experience.

SBC and Ameritech used this as an example of how they can rely on one another for ways to improve their service to IXCs. This improvement took place without the merger because AT&T had a competitive benchmark to use. A more likely post-merger outcome is that, with loss of the benchmark, service quality will be lower on average. Neither Bell Atlantic-GTE nor SBC-Ameritech have a large economic incentive to voluntarily improve service to IXCs, who they view as actual or potential competitors.

40. The nationwide structure of the industry also plays an important role in the development of industry standards. A dominant ILEC may impose standards on the industry, bypassing standards processes. The development of industry standards has always been problematic, with the local telephone companies able to control the process and adopt standards that disadvantage other players, such as IXCs. With fewer voices in the standards process, the ability of a single large firm to drive the results will increase. This is particularly important given the current evolution of broadband technologies. A more consolidated local telephone industry will have a greater ability to force anticompetitive standards on the industry.

41. The effect of the merger on dynamic efficiency through technological change is related to the benchmarking issue. Rapid technological change may well be more likely in a less concentrated industry where parallel paths of innovation lead to more experimentation and a

larger number of technological approaches are sampled.^{32/} GTE and Bell Atlantic argue that the merger will lead to economies in research and development.^{33/} While this argument may apply in a situation where a large firm acquires a much smaller rival,^{34/} it is less likely to apply in the case of a merger between two very large firms.

C. Competition for Long Distance and Bundled Local and Long Distance Service Will Be Harmed by the Merger

42. It is appropriate to analyze the competitive effects of the merger under the assumption that BOCs obtain near term Section 271 authority to provide interLATA long distance service within their regions. Based on the analysis in Section II, significant local competition is not likely in the near term. An inevitable result of the merger will be that more calls will originate and terminate in the combined territory of Bell Atlantic. This is significant because the artificial access charge advantage enjoyed by ILECs will increase as a result of the merger, as will their incentive to engage in non-price discrimination. The geographic dispersion of GTE territories

^{32/} See Declaration of Stanley M. Besen, Padmanabhan Srinagesh, and John R. Woodbury, "An Economic Analysis of the Proposed SBC/Ameritech Merger," October 14, 1998, pp. 25-30, submitted with the Petition to Deny of Sprint Communications Company, CC Docket No. 98-142 and HAI Consulting, "Economics and Technology of Broadband Competition," pp. 26-33, for a more detailed discussion of the relationships among firm size, market structure and dynamic efficiency.

^{33/} See the Declaration of Thomas W. Hazlitt, p. 8.

^{34/} The Commission made this finding in the context of approving the acquisition by SBC of the much smaller SNET. See *In the Matter of Applications for Consent to the Transfer of Licenses and Section 214 Authorizations from Southern New England Telecommunications Corporation, Transferor to SBC Communications, Inc., Transferee*, Memorandum Opinion and Order, CC Docket No. 98-25, released October 15, 1998.

does not affect this argument — the ability to discriminate is related to the total size of the customer base.

43. The artificial access advantage stems from the fact that access charges are currently priced well above costs. Excessive access charges result in subsidies from the long distance carriers to ILECs. These subsidies give the ILECs an artificial and anticompetitive advantage in the long distance market. These advantages are not the result of efficiency or innovation by ILECs. They are the result of their position as the incumbent local exchange carrier, with the consequent ability to charge competitors high prices for access. One significant problem is that ILECs can place their long distance competitors in a price squeeze.

44. Under a price squeeze, a firm supplying a monopoly input incurs less cost for the monopoly input than it charges its competitors. As a result, the competitors are unable to earn a profit even though they may be as efficient or more efficient than the monopolist. Modern economic theory recognizes the anticompetitive nature of such price squeezes. Raising the price of an essential monopoly input is a "raising rivals' cost" strategy.^{35/}

45. Imputation rules do not solve this problem. Under imputation, the monopolist charges itself or its affiliate toll provider the same rate for the monopoly input, i.e., access, as it charges its competitors. Experience in administering the imputation rules shows that these rules are hard

^{35/} See, for example, Salop, S. and D. Scheffman, "Raising Rivals' Costs," *American Economic Review*, 73, May, 1983.

to enforce in the face of incentives for the local monopoly telephone companies to abuse them — and the incumbent telephone companies do indeed have these incentives.

46. At the request of AT&T and MCI WorldCom, HAI reviewed imputation of access charges by New York Telephone (“NYT”) for its toll and Regional Calling Plan (“RCP”) services. The conclusion reached was that despite the Commission’s imputation rules and policies, many NYT intraLATA toll services were priced too low to allow competing, equally efficient interexchange carriers to make a profit. The NYT imputation analysis contained unrealistically low costs of administration and marketing. As a result of this and other problems identified, NYT placed its competitors in a price squeeze. Thus, imputation as a competitive safeguard is flawed in both theory and practice.

47. These competitive problems would not be resolved if the imputation rules were changed. Excessive access charges provide incentives for abuse. It is very difficult for regulation to overcome these incentives. With the introduction of local competition, the resources of regulators are stretched even further. The evidence in the interLATA market is that there will be a variety of pricing plans and frequent service innovations. At best, regulators will be able to perform cursory imputation reviews of ILEC offerings. By the time reviews are completed, plans that fail an imputation test may have already damaged competition. As the experience in New York demonstrates, this problem is exacerbated by the fact that the issues surrounding a proper imputation can be quite complex. The New York Commission recently found that “. . . the incumbent local exchange carrier is advantaged by the difficulties and delays inherent in

policing imputation . . ."^{36/} A New York administrative law judge described the problems in more detail.

. . . as a practical matter the [imputation] rule appears difficult to apply, and with the proliferation of competitive services, New York Telephone's rates may be increasingly difficult to police for imputation failure . . .staff reported in July 1996 that New York Telephone's personalized rate plan failed the imputation standard. Despite filing of tariff revisions, New York Telephone conceded and the Commission found that the service still failed imputation in July 1997.^{37/}

The bottom line is that pricing access at economic cost is an essential competitive safeguard. If ILECs are not earning excessive profits on access, they are less able to earn low or negative margins on the non-access portion of toll rates.

48. Incumbent local exchange carriers have argued that they have no incentive to discriminate against long distance competitors because they would lose the profits they are making on access as a result. This "opportunity cost" argument is not correct; under some, empirically relevant, circumstances neither imputation nor the firm's own calculus provides the correct opportunity cost to the ILEC. First, the monopolist will have incentives to offer volume discounts or other types of discount plans that long distance competitors cannot match. On minutes of use stimulated by such plans, the long distance carrier will still pay the ILEC full access charges, but the ILEC will recognize that its marginal cost of access is less than a long distance carrier's marginal cost of access. It will therefore be able to profitably offer consumers

^{36/} See *Opinion and Order, Establishing Access Charges for the New York Telephone Company and Instituting a Targeted Accessibility Fund*, Opinion 98-10, June 2, 1998, p. 12, fn. 2.

^{37/} *Recommended Decision* of Judge Stein in Case no. 94-C-0095, January 23, 1998.

deeper discounts. These discounts are not due to efficiency or innovation, but are due simply to the fact that access charges are priced above cost for competitors.

49. Second, if the monopoly telephone company is subject to an explicit or implicit profit cap from regulators, it will not perceive the same cost of discriminating against competitors as when this is not the case. In other words, pricing its own long distance services without regard to access charges may be profitable. Its access profits will fall, but it may avoid a general rate reduction. In addition, it will gain a competitive advantage against its long distance rivals.

50. Third, above cost access charges distort competition because the ILEC can profitably engage in non-linear pricing strategies (e.g., volume discounts or multi-part declining tariffs) that IXCs cannot profitably match. Under these pricing strategies, usage charges can be reduced all the way to marginal cost. The marginal cost floor for an IXC is the per minute access charge paid to the ILEC while the marginal cost floor of the ILEC is the true marginal cost of access. Because the ILEC's private marginal cost of access is far less than an IXC's private marginal cost of access, it can profitably offer non-linear pricing packages for its long distance service (or bundles that include long-distance and local services) that include deeper discounts for marginal long-distance users than can the IXCs, which cannot internalize (and thus eliminate) the distortion created by above-cost prices for access.^{38/}

^{38/} See Declaration of Kenneth C. Baseman and Frederick R. Warren-Boulton on Behalf of MCI, CC Docket No. 97-208 (*In the Matter of BellSouth's Application for InterLATA Authority in South Carolina*), paragraphs 27 and 28 for a more detailed explanation.

51. Mergers among ILECs exacerbate the problems discussed above because mergers will result in a larger number of ILEC calls both originating and terminating within territory. This increases the total access charge advantage accruing to the ILEC. Access charges have fallen in recent years, reducing the magnitude of the advantage. Nevertheless, access charges remain well above costs and continue to account for a substantial portion of the total costs of IXCs.^{39/}

52. The Commission reviewed this argument in the context of the Bell Atlantic-NYNEX merger, concluding that the problem was not sufficient to justify disapproving the merger in light of other regulatory rules concerning price squeezes and its expectation that Bell Atlantic would comply with market-opening conditions imposed by the Commission in connection with the merger.^{40/} However, since the Commission review of that merger, it has become even more apparent that competition is unlikely to move access charges towards cost. As discussed above, local exchange competition is not developing rapidly.

53. The fact that GTE has not monopolized long distance within its territories does not invalidate the above argument. GTE has been able to gain a nine percent long distance market share in a short period of time.^{41/} This is far greater success than any other pure reseller. Our understanding is that this success has been achieved despite the fact that GTE's long distance

^{39/} Usage-based access charges have fallen even faster than total access charges because access charge revenue requirement has been transferred to fixed rate elements such as the PICC or explicit universal service requirements.

^{40/} Bell Atlantic-NYNEX Order para. 115.

^{41/} See Merrill Lynch, "GTE Corp.," October 20, 1998, p. 2.

prices are higher than those of its competitors.^{42/} A similar phenomenon has occurred in SNET territory. This suggests that three forces are at play. First, some consumers have a preference for one-stop shopping and are willing to pay a premium for it. Second, the ILECs that are integrated into long distance service are able to charge a premium for the service because there is no effective local competition to bid the premium away. Third, GTE has a relationship with every customer and may through discrimination steer them to its long distance service even if they do not have a particular preference for one-stop shopping. The GTE and SNET experience does not show that Congress was wrong when it established safeguards for BOC entry into long distance. In fact, SNET achieved its market position in part on its ability to terminate an AT&T billing contract, which had the effect of reducing AT&T's ability to compete for the customers interested in one-stop shopping.^{43/} Finally, because of its geographically splintered structure, only about 12 percent of the calls originating in GTE's territory also terminate there — compared to a 40 to 50 percent figure for the BOCs prior to the current merger wave.^{44/} This leaves GTE with less incentive to discriminate than a BOC. If the GTE and Bell Atlantic territories are merged, the percentage of calls originating in current GTE territory and terminating in the joint territory will increase substantially, as will the percentage of calls originating in the old Bell Atlantic territory and terminating in the new combined territory.

^{42/} Merrill Lynch reports that GTE was able to acquire its market share “without crashing the LD pricing structure.” *Id.*

^{43/} See Baseman and Warren-Boulton. *op. cit.*, paragraph 25.

^{44/} See B. Douglas Bernheim and Robert D. Willig, The Scope of Competition in Telecommunications, American Enterprise Institute, 1996, p. 47.

54. The competitive problems associated with premature Bell Atlantic entry would be as great if Bell Atlantic provides interLATA service through a wholly owned affiliate GTE as through another affiliate that complied with the separation requirements of Section 272. GTE's long distance operation would effectively become affiliated with the monopoly local exchange carrier in all of Bell Atlantic's territory. There would be a significant risk that all of the anticompetitive behavior that the Section 271 safeguards are designed to minimize would occur. The Section 271 safeguards must be satisfied before Bell Atlantic can safely be allowed to provide these services, either directly, or through the GTE Trojan Horse.

55. The merger may also reduce the prospects for local competition within the territories of the merged firm. Local and long distance services will likely be offered as a bundle. Customers who choose Bell Atlantic-GTE local and long distance service bundles will be lost to CLECs. The access charge advantages the ILECs enjoy (because they are uniquely able to integrate around the problem that overpriced access charges create for IXCs) will result in a smaller potential market for their local competitors. This, in turn, will make it more difficult for independent entrants to reach a viable size. The effects on local markets are discussed further in the next section.

56. Non-price discrimination will also become more likely with a merger. A merged firm degrading quality will have a greater impact on its long distance rivals than non-merged firms because a higher proportion of the independent rivals' calls will both originate and terminate within region. That is, discrimination will carry a higher pay-off after a merger. This incentive

is exacerbated by the fact that the probability of detection of discrimination will be reduced by the loss of benchmarks.

57. The risk of technical discrimination is actually higher now than it has been in the past. The deployment of new signaling systems, intelligent network architectures, and the growth of broadband applications are all leading to different and more complex forms of network interconnection. This in turn increases the opportunity to discriminate. To take the Advanced Intelligent Network (“AIN”) as an example, an ILEC can refuse to interconnect at critical points or to convey essential information messages across the network. Instead of refusing to cooperate, the ILEC can choose to cooperate in a painfully slow way – with the same ultimate result. It can also put competitors at a substantial disadvantage by slow-rolling their requests for interconnection based on unjustified claims of technical infeasibility or lack of capacity. Regulators have a difficult time refereeing technical disputes of the sort that would be created. The implication is that competitors will not be able to design customized applications for customers that the ILEC would be able to provide – not because the ILEC is more efficient but only because the ILEC controls the last mile.

58. Of course, another problem is that simply by having to ask for new or special forms of interconnection to meet special customer needs or develop new products, IXCs are put at a disadvantage. The ILEC can delay provision of the necessary interconnection until it is ready to market the same service.

IV. THE ADVERSE EFFECTS FOR LOCAL COMPETITION FROM BELL ATLANTIC'S ACQUISITION OF GTE

59. Bell Atlantic and GTE argue that their merger is in the public interest because the new Bell Atlantic will jumpstart local exchange competition by investing aggressively in out-of-region facilities that will be the catalyst for competition against other ILECs.^{45/} In section A, we discuss the companies' out-of-franchise activities and plans for local competition. In section B, we explain why the merger is unlikely to result in out-of-franchise entry that would not soon have occurred anyway, but is likely to eliminate an incentive for GTE to use its proximity to BOC urban centers to sell local inputs to competing entities trying to satisfy one-stop preferences of major corporate customers. In section C, we explain why the merger will likely reduce local service competition within the Bell Atlantic and GTE service territories.

A. Bell Atlantic's and GTE's Plans for Out-of-Franchise Local Entry.

60. Bell Atlantic acknowledges the merger will reduce local competition in Virginia Beach, where it will not pursue a plan to compete (in a venture with Cox Communications) against

^{45/} Bell Atlantic and GTE clearly possess technical and financial resources for entry better than, or at the very least as good as, any other entrant. Nevertheless, they each indicate that independent out of region local entry on any significant scale will not generate returns sufficient to justify the investment. Thus, in the Application they recognize that enormous entry barriers remain in local service. This position completely undermines claims that the IXCs and stand-alone local entrants have been timing and scaling their entry so as either to prevent BOC entry into long distance service under the 271 process or to "game" the regulator into requiring lower rates or better terms for BOC services or UNEs. If GTE (who has no 271-based strategic motive to avoid out-of-region local entry) finds such entry unprofitable, one need not look for subtle, strategic reasons why MCI WorldCom, AT&T and others have not entered as quickly as they initially hoped. There are substantial barriers to local entry for them as well. It is ironic that Bell Atlantic castigated other local entrants for not entering sooner or on a broader scale, when its own out-of-region investments in local service were minuscule.

GTE.^{46/} Bell Atlantic also notes that it has competed against GTE to provide service at Dulles airport, in the Virginia suburbs of the District of Columbia. It argues that any loss of competition in Virginia is inconsequential. Bell Atlantic notes that at one point it was studying entry into GTE exchanges adjacent to its existing service territories in Virginia and Pennsylvania. It says it has abandoned any consideration of such entry, and no one has been authorized to even study the economics of such entry the NYNEX acquisition.^{47/} Bell Atlantic provides no information about any pre-merger plans it may have had to enter local markets in states outside its service territory.

61. GTE indicates that it has attempted entry as a reseller in a few local markets adjacent to its existing LEC operations. However, it says that discounts available to resellers are too small to support a profitable operation. It has therefore found that profitable entry must be at least partially facilities-based. However, at the small scales it has achieved, it cannot justify investing in facilities.^{48/} Its entry thus far has focused on mid-sized businesses. It has not attempted to

^{46/} Declaration of Hugh Stallard (attached to BA-GTE Appl.) (“Stallard Aff.”) at p. 5.

^{47/} Stallard Aff. at p.2.

^{48/} GTE’s observation here is particularly poignant. It has argued in Section 252 proceedings that host ILECs will voluntarily share their economies of scale and scope with new entrants by selling them inputs at prices determined according a “market-based” variant of the efficient component pricing rule (M-ECPR). It, and the BOCs, have generally been required by state regulators to sell UNEs at prices lower than M-ECPR levels (but higher than true TSLRIC levels). Yet in its role as an out-of-franchise entrant, GTE finds that it still suffers from diseconomies of scale. Apparently it cannot find ILECs to share voluntarily with it their economies of scale and scope.

market to residential consumers because the “cost of acquiring and serving consumer customers was prohibitive”.^{49/}

62. The companies say that the merger, by combining GTE’s locations next to BOC urban franchises outside the Bell Atlantic territory with Bell Atlantic’s existing relations with large businesses in the Northeast, will enable it to begin providing facilities-based local competition in 21 cities. Bell Atlantic, which under this theory is providing the important increments in traffic, would have had incentives for out-of-region local entry even without the GTE merger. But the application is silent on the issue of how many of these 21 cities Bell Atlantic might have entered anyway. The application is also silent on whether Bell Atlantic might have entered any GTE franchise areas outside the Northeast.

B. The Merger Is More Likely to Reduce than to Enhance Local Competition and Competition for Bundles of Local, Long Distance, and Other Services.

63. Bell Atlantic-GTE’s public interest argument rests on several assumptions. First, they claim GTE’s franchises are themselves not particularly attractive locations for out-of-franchise entry by other BOCs or CLECs, because they are largely suburban and rural and therefore lack the necessary concentrations of large businesses. Thus, they argue that Bell Atlantic could not

^{49/} Kissell affidavit at p. 2. GTE, like other CLECs, says it has not served residential customers because the poor profit potential does not warrant the necessary investment. The BOCs have generally claimed that the IXCs are strategically avoiding residential local competition in order to avoid triggering 271 authority for the BOCs. GTE’s experience lends credence to the IXCs’ denial of the charges, since GTE is allowed to provide interLATA service now, without going through the 271 process.

be interested in entering GTE's territories. Interestingly, the Bell Atlantic affidavits address only its studies of entry plans.

64. Second, they argue that, because of the proximity of GTE's facilities to important urban areas where the BOCs provide service, the sharing of facilities in GTE's franchise areas can be used to reduce the costs of local entry in these attractive, adjacent, urban areas. Third, they argue that Bell Atlantic's relations with large businesses headquartered in the Northeast allow it to provide the concentrations of traffic volume that make feasible investment in facilities near GTE's local exchanges whose average costs depend on volume. Apparently, the potential for cost-effectively entering adjacent local markets from neighboring GTE exchanges exists only outside of Bell Atlantic states because the parties tell the Commission that GTE would not enter any of Bell Atlantic's states on its own.^{50/} Therefore, the parties suggest that, their merger will enhance competition for local and bundled services. The GTE franchises "enable" Bell Atlantic to enter local service out of region that it otherwise could not afford to undertake. Fourth, the parties assume demand will be strong for bundled local and long distance services, and they

^{50/} We note that less than five months ago one of the GTE affiants supporting this application, Debra Covey, told the West Virginia Public Service Commission that GTE was in fact going to compete against Bell Atlantic for local exchange service in West Virginia. See Transcript of Proceedings, at 119-20, *WorldCom, Inc., Petition for Consent and Approval to Acquire All Outstanding Shares of Stock of MCI Communications Corporation*, Case No. 92-0347-SWF-CN (June 25, 1998) (excerpts attached as Ex. __ to MCI WorldCom's Comments) ("GTE Communications Corporation, our C-LEC, which I am employed by, intends to offer local service here [in West Virginia] next year" and "as a C-LEC we will offer bundled services, wireless paging, Internet, local"); *id.* at 124 (GTE intends to compete in 100-200 mile radius from existing territories).

assert, without specifying how, that the merger will enhance competition for these bundled services.

65. The first assumption — that the GTE franchise areas are not attractive targets for out-of-region entry by the BOCs or CLECs so Bell Atlantic is not likely to ever enter there — is clearly overstated. The premise is that GTE's franchises are mostly in suburban and rural areas, therefore are not likely candidates for local competition. It is true that in the early years of the Bell system's monopoly, it consciously tried to achieve and maintain monopolies in major cities, and it sometimes left to other companies the higher cost, less urbanized areas. Since GTE was not part of the Bell system, it was not part of the Bell system monopoly over most urban areas. However, GTE did manage to end up with operations in several important urban areas, such as Dallas, Tampa and Los Angeles. These cities hardly seem less attractive prospects for entry than the twenty-one cities the parties identify as attractive candidates for entry after they merge. Given the logic of the urban/rural categorization, GTE should offer to divest operations in these cities so as to preserve Bell Atlantic's incentives to enter there.

66. Moreover, if it is true that most GTE's franchises are unlikely targets for entry by other local carriers, the logical implication is that it is especially important that GTE remain independent of the BOCs. One explanation for why the BOCs have not attempted to provide local service in one another's region is that each fears that such entry will lead to retaliatory entry within its own region by the BOC whose territory it entered. The threat to enter GTE's franchises on a retaliatory basis is less credible if there are no profits to be earned. On this basis, if GTE is right that its regions are less desirable entry targets, then GTE is an especially credible

potential entrant because it is less likely that any ILEC against whom it enters can retaliate effectively.

67. The second assumption — that many of GTE's facilities are close enough to major population centers to meaningfully reduce the costs (by sharing facilities) of local entry in adjacent areas — does not justify this merger. Recall that GTE's position is its own territories are not attractive for entry, and that standing alone it cannot earn a sufficient return to warrant entering adjacent urban areas where entry is inherently more attractive, even with the leg up of being able to leverage off geographically proximate facilities, because it sees insufficient demand to justify the investment. There are two major problems with this formulation. First, GTE has in fact been attempting to enter local markets out of its franchise areas, and has announced plans to invest substantially more in the future.^{51/} And it has established non-LEC businesses in Bell Atlantic's territories (a substantial presence in GTE Internetworking and long distance activities) from which it would make sense to base a local entry strategy there. Thus the premise that GTE has the ability to enter local markets only adjacent to its LEC franchises is

^{51/} *GTE Announces Initiatives to Become a Leading National Provider of Telecommunications Services* (May 6, 1997) ("Simply put, GTE will become a leading national 'one-stop' provider of local, long-distance, Internet and wireless services."); *GTE 1997 Annual Report Financial Data* ("By packaging products and services, such as traditional wireline, wireless, long-distance and Internet services on one bill, GTE is positioned to capture high-value, high margin customers, both inside and outside of franchise territories."). A copy of GTE's May 6, 1997 press release is available over the internet at <http://www.gte.com/AboutGTE/news/050697.html>. A copy of GTE's Annual Report Financial Data is available over the internet at <http://www.gte.com/AboutGTE/annual1997/finreview2.html#Growth>.

inconsistent with GTE's actions prior to announcement of its merger with Bell Atlantic and contrary to its established presence in Bell Atlantic's region.

68. In addition, the parties' argument that GTE needs Bell Atlantic's concentrated long distance traffic to enter local markets adjacent to its LEC franchises is highly suspect. If GTE does not have to fear local entry by others into its suburban franchises (because, as GTE argues, they are not attractive targets for entry by anyone), why wouldn't it attempt to solve its volume problem by investing in adjacent, out-of-franchise facilities and leasing or renting capacity to other firms, such as the IXCs, who it says now have the demand volumes to support construction of new facilities?^{52/}

69. One possible explanation is that Bell Atlantic-GTE do not see the cost synergies as being all that significant, which implies that controlling GTE's facilities will not affect materially the costs for out-of-franchise entry. A second explanation is that the market for bundled local/long distance service is still nascent, so it would not pay GTE to construct the facilities yet because demand from IXCs and out-of-region BOCs will not soon be sufficient to fill the facilities. In that case, however, the relevant forward-looking question is why, as demand develops, the public interest wouldn't better be served by keeping GTE independent. It would have

^{52/} This questions is especially relevant to GTE's national fiber network. The parties' merger application repeatedly refers to these facilities near Phoenix and Denver as being an "enabler" for Bell Atlantic's out-of-region entry. The parties never explain why GTE can't simply sell capacity on those facilities to Bell Atlantic, if and when Bell Atlantic gets around to entering out of region. GTE has no incentive to resist that capacity sale, since, as it points out, it does not have local exchanges near Denver or Phoenix against which Bell Atlantic would be competing.

commercial incentives to lease capacity to several customers (e.g., MCI WorldCom, BellSouth and Bell Atlantic), whereas when Bell Atlantic owns GTE, it would have the incentive to use the facilities to support only its own entry. This is because, under GTE's logic, Bell Atlantic has something that GTE does not possess: established business relationships with the largest corporations. Thus, GTE could not compete for the end-to-end business, so it would have incentives to lease facilities to all contestants for that business.^{53/}

70. We turn now to the third step in the logic – that Bell Atlantic brings to the BA-GTE merger table established business relationships with large business customers that GTE does not possess. This premise is clearly overstated, at the very least. For example, GTE Internetworking already has existing relationships with large corporate customers, including many who are located in Bell Atlantic's region. And GTE operates its Internet/long distance network in the Northeast.

71. Moreover, even accepting the counterfactual premise that GTE is powerless to enter local service in the Northeast, it does not follow, as the parties suggest, that Bell Atlantic needs GTE in order to “enable” it to enter local service out of region in the near future.^{54/} Bell Atlantic's

^{53/} An independent GTE investing in out-of-franchise local entry would provide both actual competition to the incumbent ILEC and useful benchmarks.

^{54/} The parties also apply the “enabling” argument to brand names, claiming that the merger is needed to enable them to invest in a brand name to challenge other major brands in telephony. This argument is a red herring. Brand names matter little to major business customers. Bell Atlantic and GTE say their merger is most likely to “enable” them to reach Fortune 500 accounts who are contemplating some sort of sole-source arrangement with a single vendor. For smaller business customers and residential customers, brand names are useful to the extent they provide accurate summary information about the firms' reputations and qualities. However, Fortune 500 accounts will directly investigate and extensively test the services of any

relationship with large business customers gives it an incentive, with or without the merger, to enter local markets out of region if those customers show an interest in end-to-end service. The incentive for out-of-region entry is especially strong if Bell Atlantic begins losing high margin local telephone business with major corporations to rivals offering end-to-end service.

72. The economics of such defensive entry are far different than the economics of offensive entry. The returns from offensive entry (entering out-of-region local service before there is meaningful in-region local competition) are simply the (relatively low) profits from competing as a small player against the host ILEC. The returns from defensive out-of-region entry include both the out-of-region profits from local service plus the larger monopoly profits from local service within region that the ILEC retains if it keeps local business, rather than losing it to CLECs who have established a nationwide footprint.

73. Thus the notion that ILECs may enter the local telephone business out of region for defensive, but not offensive, purposes has logical appeal. However, if this argument is correct, then this merger is not needed to induce Bell Atlantic to enter local service out of region. As ILECs begin to lose multilocal business to facilities-based local entrants in their regions (such as MCI WorldCom), they will begin investing out of region to protect their customer base. A logical implication is that Bell Atlantic's current business plans for out-of-region local entry are largely irrelevant to its likely future actions. It may have no current plans for out-of-region

vendor before committing to them on a sole source basis. In addition, it is hard to imagine that any Fortune 500 telecommunications manager is not intimately familiar with the names GTE or Bell Atlantic given how long they have monopolized local telephone service.

local entry because it has not yet seen a significant enough loss of high margin, in-region local business. In that case, the returns from facilities-based local entry out of region are not particularly attractive, as today's CLEC's, including GTE, have found.^{55/}

74. The factual premise for the fourth assumption — that demand for end-to-end service (which may, but need not necessarily, entail bundled local and long distance services) will turn out to be strong — may or may not turn out to be valid, but certainly many firms, including MCI WorldCom, have invested heavily in facilities that would satisfy any such demand. Local markets are not competitive, but the major facilities of large Fortune 500 firms are sometimes served by multiple suppliers. MCIWorldCom, TCG, and a number of smaller CLECs have facilities in major cities throughout the country. The competitive benefits of an additional entrant into this segment of the market are correspondingly reduced.^{56/}

^{55/} GTE's experience confirms that entry into local telephony is time-consuming and costly. Very large barriers to entry remain in local markets. And the UNE procedures in place have done little to change that fact. The UNE provisioning process is not working. Moreover, the prices are too high. The practical reality is that, to the extent local entry is occurring, it is predominantly with facilities constructed by the entrant. MCI WorldCom has argued that local entry cannot be viable if it depends substantially on UNEs purchased under the terms and conditions that now prevail from an entity, the ILEC, with no incentive to make the transaction work. Bell Atlantic and GTE have reached the same judgment. They have decided that out-of-region local entry must be predominantly facilities-based and they cannot rely substantially on UNEs purchased from the out-of-regions ILECs on the terms and conditions at which they are currently available (at least during the early stages of entry).

^{56/} The benefits of competition could, of course, be extended to more customers if ILECs were to make available unbundled network elements and wholesale services on non-discriminatory terms.

75. Indeed, in our opinion this merger will affect adversely the development of competition for bundled services because it will strengthen each partner's bottleneck control over local facilities within region. There is already ample competition in the long distance portion of the bundle, but not for the local portion of the bundle. Permitting this merger to occur, as discussed below, will make even more remote the possibility that such local competition will ever occur in Bell Atlantic's and GTE's monopoly regions. To that topic we now turn.

C. This Merger Will Reduce Local Service Competition in the Bell Atlantic and GTE Territories, and Thereby Harm Consumers.

76. Disapproving the merger provides the best chance for local competition to develop in Bell Atlantic's and GTE's territories. Bell Atlantic's and GTE's defense of their merger proposal explicitly recognizes that entry into local service is extraordinarily difficult. The proposal also recognizes that the market opening measures for local service that thus far have been implemented under the 1996 Act have not opened local markets very much.

77. GTE and Bell Atlantic are in effect conceding that out-of-region local markets are not yet "open to competition," which the 1996 Act makes a prerequisite for BOC interLATA authority. GTE and Bell Atlantic are as well positioned as anyone in terms of the technical and financial capabilities for local entry. If entry is unprofitable for them, the market is not "open to competition" in any meaningful economic sense.

78. If the local inputs needed to compete with ILECs for the business of major business customers could be procured in a competitive environment, then out of region local entry by Bell

Atlantic-GTE would not be needed to satisfy these customers. However, ILECs who do not yet face established, facilities-based local competition can be expected to discriminate against anyone (including operations of out-of-region ILECs) trying to take away local service revenues.

79. ILECs have an incentive to provide UNEs on a non-discriminatory basis to entities that are both capable of entering with their own local facilities and in a position to offer sole-source or one-stop shopping to large corporate accounts. In this case the ILEC has an incentive to provide good UNE service in order to avoid losing all local revenues flowing from the business of those customers. This incentive is eliminated by the merger if Section 271 authority has also been granted prematurely (e. g. before local competition has taken root and forced access charges far closer to economic cost). The merged company will move to provide its own one-stop shop immediately, and therefore will be able to compete for the patronage of its own Fortune 500 customers on an end-to-end basis. It will not have to consider whether to make UNEs available on a more reasonable, competitive basis in order to keep a portion of the business of these large customers. Thus, a Bell Atlantic-GTE merger coupled with Section 271 authority raises serious risks to the possibility of effective local competition by reducing the chances Bell Atlantic or GTE otherwise might have moved, as local competition developed, to provide UNEs on more reasonable terms.

80. If Bell Atlantic does not provide in-region interLATA service, the merger still creates a serious risk that it will be able to seriously disadvantage smaller competitors for national/local accounts. The smaller competitors would include CLECs and other ILECs who might consider

out-of-region entry. By definition, these carriers have less extensive local facilities in place. Bell Atlantic-GTE could install out-of-region switches and fiber rings so as to provide national customers with the same telecommunications interface in all areas where it had its own facilities. Without interLATA authority, Bell Atlantic would have incentives to set up its service so that customers could use it with any long distance service. But because there is no serious disagreement that long distance service for large corporate amounts is quite competitive, Bell Atlantic need not fear that long distance carriers will purposely design their service so as not to work well with its multilocal service. Customers who prefer Bell Atlantic's multilocal local service features will search out long distance services that interconnect well with Bell Atlantic.

81. But with respect to the local facilities used in these product bundles, asymmetrically large ILECs, such as the proposed Bell Atlantic-GTE and SBC-Ameritech, will be better able to win a discrimination game against other competitors for multilocal accounts. The mergers are contrary to the public interest because larger ILECs can discriminate more effectively than smaller ones. Consider a customer for whom 80 percent of its traffic originates and terminates in Bell Atlantic's territory, and 20 percent of which flows between points in Bell Atlantic's territory and the territory of another ILEC. In competing for the multilocal business of that customer, Bell Atlantic has a substantial advantage. If the smaller ILEC wants to compete for that customer, it will need to build its own facilities or procure UNE's from Bell Atlantic for 80 percent of the customer's business. CLECs would have to build facilities or buy UNEs for 100 percent of the locations. Bell Atlantic will need to build facilities or buy UNEs to serve only 20

percent of the customers requirements. For UNE-based entry, Bell Atlantic can discriminate against rivals for a far greater volume of business. And Bell Atlantic's investment to build around such discrimination is far smaller than the other ILEC, because it already provides facilities-based service for four times as many calls. This gives Bell Atlantic both the incentive and ability, without fear of effective retaliation, to discriminate against other firms attempting to meet the demand for multilocational service.

82. It then may make (private) sense for GTE-Bell Atlantic to build their own out-of-region local facilities. It will then control both local ends for far more major clients than any other ILEC or non-ILEC competitor with fewer local facilities in place near the larger business customers' locations. Because it will be far larger than other competitors, it can inflict far more discrimination on others than it will have to incur itself. In these circumstances, the post-merger Bell Atlantic — like the post-merger SBC — will find itself uniquely well-positioned to win the business of Fortune 500 clients, since it can offer service far less prone to discrimination than IXCs and other ILECs.

83. To see how this works, consider the following simple example. Suppose that if an ILEC provides "good" UNE services, other local carriers can profitably serve corporate customers using a UNE-based strategy. However, currently the ILECs' incentives are to offer "bad" UNE services, which prevents UNE-based local competition. Offering UNEs on this basis allows the ILEC to keep all local revenues from those corporate accounts. The ILEC would obtain lower

revenues and profits from selling UNEs.^{57/} So, while the ILEC could provide good UNE service to its competitors, it chooses not to do so. Rather, it provides them with bad UNEs so as to forestall local competition. It provides good service to itself (but these are not called UNEs).

84. This situation can be understood using the theory of network externalities. In a competitively structured market, firms have an incentive to interconnect on mutually beneficial terms. In this context, this means that firms have an incentive to open their networks to other competitors through provisioning UNEs and terminating network interconnection on reasonable physical and financial terms and conditions. To not do so means the loss of business to other firms. However, if Bell Atlantic gets too large, it loses any private incentives to maintain compatibility. It will have more to lose than to gain by opening its networks. When it gets large enough, it has incentives to “tip” the system to incompatibility.^{58/}

85. Premature interLATA relief exacerbates the problem. Bell Atlantic can still provide good service to itself, yet continue to provide bad UNE service to others. It is not backsliding on the performance of UNEs it sells to others, it just never offers UNEs of any serious commercial

^{57/} As we noted above, if (as) local competition develops (without interLATA authority) at some point the ILECs incentives change. It will have incentives to provide good service to other carriers because they have competitive alternatives of getting good quality service from other local facilities-based competitors. At that point, the ILEC finds it profitable to stop discriminating (or to begin providing more compatibility), for it is better for the ILEC to get the UNE revenues than nothing at all.

^{58/} Jean-Jacques Laffont, Patrick Rey, and Jean Tirole, "Network Competition: 1. Overview and Nondiscriminatory Pricing," The Rand Journal of Economics, Spring '98, pp. 1-37.

value. In these circumstances, the Bell Atlantic-GTE merger creates additional incentives for discrimination (for less compatibility offered to customer/competitors). The merged firm now finds it profitable to be the only provider of high quality one-stop (local plus interLATA) service, and it now has stronger incentives to resist local competition (because it now captures all one-stop revenues that previously were captured by no one).

V. MERGERS BETWEEN MAJOR ILECS (SUCH AS BELL ATLANTIC-GTE AND SBC-AMERITECH) THREATEN COMPETITION FOR ADVANCED SERVICES AND INTERNET SERVICE

86. The Commission is currently concerned about competition for the advanced services that will bring broadband Internet access to residential and small business customers.^{59/} A key fact in the development of the Internet is that there have been no dominant firms involved in its evolution. Due to the Line of Business Restrictions in the MFJ,^{60/} BOCs were originally restricted from providing information services. After this restriction was eliminated, the BOCs claimed that the interLATA restriction limited their ability to provide information services. Despite constant claims by the BOCs that these services would not reach the mass market without their involvement,^{61/} the Internet flourished. Both large and small entrepreneurs were able to innovate and invest in Internet technology. As explained below, the mergers between

^{59/} *In the Matters of Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket No. 98-147, Memorandum Opinion and Order and Notice of Proposed Rulemaking, released August 7, 1998. ("Broadband NPRM")

^{60/} *U.S. v. A.T.&T.*, 552 F.Supp. 131 (D.D.C. 1982).

^{61/} See *Memorandum of the Bell Companies in Support of Their Motion for a Waiver of the Interexchange Restriction to Permit Them to Provide Information Services Across LATA Boundaries* (D.D.C. filed April 24, 1995).

Bell Atlantic and GTE and Bell Atlantic and GTE will have negative consequences for development of both broadband and Internet competition.

A. Broadband Competition

87. There are many ways in which an ILEC can discriminate against competitors that are dependent on access to the ILEC networks to reach customers. Discrimination is a particular problem when technologies are changing.^{62/} Discrimination can be built into new network architectures and new technologies can be deployed to favor the advanced services provided by the ILEC.^{63/} For example, the ILECs generally have been trying to limit competition for new DSL technologies by refusing to allow customer/competitors to purchase essential facilities needed to provide broadband services. Rather, the ILECs insist that would-be competitors to its broadband offerings must purchase an unbundled loop and collocate their own equipment to provide DSL service to their customers. The problem is exacerbated by the fact that ILECs in general are refusing to allow efficient collocation, and imposing a variety of other restrictions that have the effect of limiting the ability of competitors to offer competitive versions of xDSL.

88. The problem will only become worse as broadband technology evolves. xDSL technology provided over copper loops has been available for almost a decade and is fairly well understood. The ILECs are deploying digital loop carrier (“DLC”) systems to more and more of their customers. With DLC systems, competitors may require access to electronics located at the

^{62/} See Baseman and Warren-Boulton, *op. cit.*, at paragraphs 20-24.

^{63/} See Economics and Technology of Broadband Deployment.

fiber-feeder interfaces in the loop. So far, no ILEC has allowed the subloop unbundling required to provide this access. With evolving technology, it may be possible for ILECs to select for strategic reasons a broadband/DLC architecture that does not allow efficient unbundling at either the subloop or the wire center.

89. The merger will have negative effects on the evolution of broadband competition primarily because it will eliminate important benchmark competition. It is during a period of rapid technological change that competitive benchmarks can be particularly revealing. Broadband technology is relatively new and has not evolved to the extent that traditional circuit switched technology has evolved. In these circumstances, different firms will be experimenting with different technologies and approaches to providing the service. To the extent that major ILECs make independent broadband technology choices, adopt independent collocation policies, or make independent unbundling decisions, the Commission is provided with invaluable information. The loss of a benchmark is particularly significant with this merger because, as an established nation-wide Internet player, GTE has an interest in using its considerable expertise as a local exchange carrier to induce other ILECs to open their networks to allow broadband competition to develop rapidly. This will be less likely once it is affiliated with Bell Atlantic.

B. Internet Issues

90. There is also a substantial risk to Internet service providers. Some parties opposed the MCI WorldCom merger, arguing it created the potential for MCI WorldCom to monopolize the Internet backbone. MCI WorldCom's Internet operations were divested before the merger was

approved. The Internet concerns struck us as theoretically valid, but empirically suspect, since it was not at all clear that (given the extensive building of backbone and other routing facilities by many other players) there was any danger that there was in fact a backbone bottleneck or that MCI WorldCom could gain control of it.

91. On the other hand, there is clearly a local bottleneck. As discussed above, the ILECs thus far have been able to restrict competition for that bottleneck by refusing to provide competitor/customers with the essential elements they need and are entitled to under the 1996 Act in order to be able to compete. The bottleneck and the many ways the ILECs can discriminate do not go away simply because the network is evolving to incorporate local broadband technologies such as xDSL. Indeed, local broadband technologies provided over ILEC monopoly networks may become the preferred method of access to the Internet. As such there is great risk that the bottleneck will simply evolve to encompass the new technologies. ILEC mega-mergers exacerbate that problem. The potential problems are discussed below.

92. There is a great risk that ILECs will be able to favor their own ISPs.^{64/} This, of course, is a risk any time a vertically integrated monopolist competes in regulated monopoly and competitive markets. The problem will be exacerbated to the extent that xDSL access becomes a significant means of accessing the Internet. It is in fact likely that xDSL, or other forms of

^{64/} See *Complaint of the Department of Public Service and the Office of Attorney General, Before the Minnesota Public Utilities Commission, In the Matter of an Investigation Into U S West Communications Provision of MegaBit Services*, Docket No. P421/EM-98-471, September 10, 1998.

broadband access, will become increasingly significant as the consumer demand for high bandwidth Internet applications grows.^{65/}

93. Current Internet access for most end users is through dial-up local connections. Discrimination against ISPs to date has been limited due to the fact that ILECs have been late in entering the market and the fact that the pricing, technology and provisioning of these connections is standardized. By contrast, xDSL connections will be subject to pricing, technological, and provisioning uncertainty. This will open up the opportunity for discrimination against CLECs and ISPs.^{66/}

94. The problems discussed above, of course, are likely to occur with or without the merger. However, the negative consequences for the development of the Internet are exacerbated by the merger. As described in Table II, after the merger, Bell Atlantic-GTE and Bell Atlantic-GTE will control almost 70 percent of the lines between them. These lines are the true bottlenecks to the Internet. If SBC-PacTel-SNET-GTE and Bell Atlantic-NYNEX-GTE leverage their advantages in the provision of broadband access into a significant position in the ISP business, the problems will only be worse. Perhaps separately, and certainly in “gentlemen’s agreement”

^{65/} See Economics and Technology of Broadband Deployment, Section II.

^{66/} We are not suggesting that discrimination over dial-up connections can not or has not occurred. But the ILECs were not among the first movers in the ISP business. The absence of discrimination to date could merely reflect the fact that the ILECs were not in a position to benefit from discrimination, not that existing regulation is sufficient to prevent discrimination in dial-up access. Our main point, however, is that incentives for discrimination are far harder for regulators to control when technology is changing.

duopoly, these parties would have the ability to refuse to peer with other ISPs, or to discriminate in other terms in favor of their own ISPs, in precisely the ways that concerned regulators in the MCI WorldCom merger.^{67/}

95. In short, with two major suppliers of Internet bottleneck connections to end-users, there is a risk that they will act in concert to disadvantage all other suppliers. For example, by imposing discriminatory terms of interconnection on other providers, they can raise their rivals' cost of doing business.^{68/} With several smaller firms, this is less likely. Even though, prior to the mergers, individual ILECs may disadvantage ISPs in their own regions and therefore gain control over a disproportionate share of the ISP business, there would still likely be a sufficient number of large players to ensure that interconnection in the Internet business generally is on reasonable terms. There would be incentives to exchange traffic on reasonable terms since no one supplier controls a disproportionate share of the business. Recent economic analysis shows

^{67/} The problem is ameliorated if other technologies emerge to provide broadband access for ISPs. For the cable industry, at least, the prospects for effective competition from the cable industry for the last mile of Internet access are uncertain. See Barbara Esbin, "Internet Over Cable: Defining the Future in Terms of the Past," FCC, OPP Working Paper no. 30, August 1998 for a discussion of Internet over cable.

^{68/} Critics of a merger of MCI's and WorldCom's Internet businesses argued that it would be easy to customize discrimination so as to pick off one competitor at a time, as part of a divide and conquer strategy. (See "Internet Reply Affidavit of Robert G. Harris on behalf of GTE Corporation," June 8, 1998, paragraph 46, and "The Strategy of Targeted Degradation," pp. 10-13 of "The degradation of quality and the domination of the Internet" by Jacques Cremer, Patrick Rey and Jean Tirole submitted by GTE to the European Competition authorities and to the FCC in June 1998.

The Commission took those complaints seriously. If discrimination can be customized, it would clearly be feasible for the Bell Atlantic and the Bell Atlantic groups of ILECs to treat one another quite differently than they treated other Internet companies.

that in network industries, there is an incentive to cooperate as long as no single player or small set of players dominates. However, once the industry moves to an asymmetric structure (e.g., where the merged Bell Atlantic-NYNEX and Bell Atlantic-GTE substantially control more choke points on the Internet than other players), the dominant firm or firms have incentives to not cooperate with smaller firms.^{69/}

96. The negative consequences of two large firms essentially controlling the financial and physical terms of entry into the Internet business are substantial. For example, ISPs are not merely gateways to information services. They are becoming important content providers and Internet service innovators. ISPs increasingly are in the content business and the business of assisting other firms with Internet commerce through designing, hosting and managing web sites. By imposing costs on independent firms and thereby making it more difficult to enter and expand in the Internet business, social welfare could be dramatically affected.

97. The underlying public policy rationale behind the required spin-off of MCI's Internet backbone business prior to the WorldCom merger must have been that this market is capable of being monopolized by players with asymmetrically large positions. The Bell Atlantic and Bell Atlantic groups will control the majority of bottleneck local facilities necessary for Internet service. Their potential for effective discrimination far exceeds anything MCI WorldCom would have possessed, because the "last mile" bottleneck is far more secure than any temporary choke

^{69/} See Laffont, Rey and Tirole, *op. cit.*

points MCI WorldCom might have possessed if no divestiture of Internet assets had been required for regulatory approval of that merger.

98. We recognize that (unlike MCI WorldCom) the Bell Atlantic-GTE merger does not consolidate existing strong positions among two former competitors. Bell Atlantic and GTE are not now competing with one another for local customers in each others' territories, and Bell Atlantic is a minor ISP player. But they each now have a local monopoly in their home region. And the merged company will have a greater incentive and/or ability than the individual companies to distort inefficiently competition in adjacent markets, such as ISP or backbone service out of region.

99. Exactly how the incentives play out depends on other decisions the Commission and state regulators must make. If the ILECs are required by the Commission to sell xDSL UNEs at regulated rates based on forward-looking cost, then they will have strong incentives to evade the profit constraint by entering adjacent markets and discriminating against competitors. If the Commission does not require the ILECs to sell xDSL UNEs on a regulated, carrier-to-carrier basis, the xDSL consumer prices will likely still be constrained directly or indirectly by regulation. Competitors may buy conventional unbundled loops at regulated rates and attempt to assemble their own xDSL service as best they can in face of noncooperation from the ILEC concerning issues such as collocation.^{70/} Alternatively, competitors to the ILECs may attempt to

^{70/} We recognize that the Commission is addressing these issues in its Broadband Rulemaking. Separate affiliates and enhanced unbundling and collocation requirements are under consideration. To the extent that the Commission adopts suggestions made in HAI's

compete reselling xDSL service purchased at state-regulated retail rates. In each of these cases, because its xDSL profits are constrained by some form of regulation; the ILEC will want to integrate into adjacent markets, discriminate against rivals, and take profits in those markets that regulation denies it by limiting xDSL prices to less than the monopoly level.^{71/}

100. These incentives for discrimination will exist with or without the merger. However, a merged Bell Atlantic-GTE (and a merged SBC-Ameritech) will have greater ability than the companies standing alone to discriminate effectively because of their greater combined control of Internet bottleneck facilities.

101. Indeed, the Public Interest Statement filed by Bell Atlantic and GTE seems to contemplate substantial steering by Bell Atlantic of in-region Internet business to GTE's backbone. GTE's Curran argues that GTE's backbone business will obtain "access for Bell Atlantic's concentrated Northeast customer base,"^{72/} allowing it to provide these customers with

"Economics and Technology of Broadband Deployment" and in the Comments of parties in the Broadband proceeding, the problems discussed here might be ameliorated. However, as long as the bottleneck is in place and vertical integration is allowed, there will be competitive concerns. Regulation is simply not adequate to eliminate all problems when there are strong incentives for evasion.

^{71/} Of course, this is not to say that regulators ought to deregulate the ILECs' xDSL service, or that there is little to choose from among the various possible regulatory alternatives for xDSL. Based on a judgment that multiple methods of entry are necessary for local competition to develop, the 1996 Act is that ILECs should unbundle their services, offer inputs to rivals at forward-looking, cost-based rates, and offer rivals the option of purchasing ILEC services at wholesale discounts for resale to their own customers. Competitors to the ILECs should have all these options for the xDSL business for the same reasons they should have them for conventional local telephony.

^{72/} Curran affidavit at p. 2.

an unspecified array of new services. But today GTE has the same “access” to customers as the other backbone companies. None of the major national backbone companies is now a BOC, so in each BOC’s territory, each backbone provider can compete on a level playing field to attract patronage of ISPs. Bell Atlantic and GTE apparently plan to use control over “access to Bell Atlantic’s concentrated Northeast customer base” to tilt this competition in favor of GTE. They argue that the merger benefit to GTE is access to Bell Atlantic’s extensive Northeast marketing and distribution networks. But this seems merely a silly euphemism for discriminating against other backbone providers. As the parties note, Bell Atlantic is but a tiny ISP, and it does not currently provide interLATA backbone services. Thus its marketing network has no relevant experience. Preferential access to Bell Atlantic’s distribution network (the bottleneck to the end user!) is discrimination.

102. The merged super BOCs will also have incentives for monopolization of out-of-region Internet activity. That is, even if they earned the entire profit available from monopolizing in-region advanced and Internet services and if no further profit could be extracted from monopolizing adjacent or related in-region services, they still have incentives to leverage their control of the lion’s share of local Internet access into additional profits in out-of-region ISP services. For example, after entry into out-of-region Internet services (and in-region Internet services if the Commission’s interpretation of Section 271 allows it), the merged BOCs could discriminate against competing ISPs at either backbone to backbone connections, or at backbone to local interconnections. Since the BOCs will control more local Internet access after merger than before, merger will increase their ability to discriminate effectively.

103. In summary, there is a danger that Internet service will “tip” to Bell Atlantic and SBC if they are allowed to consummate their pending mergers. Competition among ISPs or backbone service providers could be seriously distorted due to these mergers. The result would be higher prices for consumers of Internet services and reduced opportunity for innovation by independent firms. This magnitude of the social risk depends on a number of factors, about which we now offer no empirical assessment. First, the risk is greater the more completely and quickly the Internet moves away from dial-up access to xDSL connections, where the potential for successful discrimination is far greater. Second, the risk is greater the lower the ultimate competitive significance of alternatives provided by CLECs or the cable industry.^{73/} Third, the risk is greater the lower the entry barriers for BOCs into the adjacent markets, since merger-related Internet problems occur only when the merged company enters (or expands from a fringe position) in a market in which it was either not present previously, or in which it was small.

104. Even if the probability that all three factors will be present in the near future is small, the Commission should still view the risks to Internet competition as serious, especially since, as we noted, GTE’s Internet business apparently plans to benefit from ISPs and end-users in the Northeast being steered to use GTE’s services. As discussed above, the Bell Atlantic-GTE merger carries very little potential for public benefits, so additional risks, such as the risk to Internet competition, add to the public interest case against the merger.

^{73/} This is not to say that the market will exhibit competitive performance if, say, the cable industry becomes a significant local player in high speed Internet access. Duopoly is not competition as we know, for example, from the cellular business. There the addition of more sources of competition, such as PCS, has benefitted consumers.

VI. A PROPERLY CONSTRUCTED STOCK MARKET EVENT ANALYSIS SHOWS THE MERGER IS ANTICOMPETITIVE

105. Bell Atlantic and GTE offer an “event study” by Thomas Hazlitt as evidence to support their application. In general, event studies are used in antitrust to assess the perception of investors in financial markets concerning the likely effects of a merger. The intuition behind the event study methodology is straightforward. Investors are betting real dollars trying to anticipate the effect of important events, such as merger-related changes in market structure, on firms’ stock market values. Various investment institutions expend considerable resources to follow events that can be expected to influence the values of widely held stocks, such as Bell Atlantic, GTE, AT&T and MCI WorldCom. Thus, the stock market’s reactions to a merger are said to be largely influenced by well-informed predictions of the actual effects of the merger. For example, if the “market” expects that a merger will generate significant efficiencies or synergies, then the combined value of the two partners’ stock should increase.^{74/}

106. There is at least some controversy within the literature over the value of event studies in assessing the effects of mergers, or other events. First, the method assumes that investors are fairly well informed, and in a good position to judge quickly the effects of a merger. Critics of

^{74/} It is the change in so-called abnormal returns to the stocks of the merging companies that is of issue. That is, the analyst is interested not in the changes in the merging firms’ stock prices, but the changes in those prices after netting out the aggregate effects on stock-market wide changes occurring at the same time. Hazlitt computes abnormal returns by netting out from the changes in individual company stock prices the change in the S&P 500 on the same day.

To keep the discussion in the text as simple as possible, we will sometimes refer to changes in stock prices in the merger window. But in each case we are referring to the abnormal returns to the stock prices.

event studies point out that many mergers to which investors reacted favorably turned out later to be disasters for the shareholders. Promises of synergies or efficiencies sometimes are not met, and the costs of merging and running two organizations are sometimes far higher than expected. Second, the predicted effects of a merger may sometimes depend on the size of the “event window,” and there is not yet a well-recognized basis for deciding which window is most appropriate. The event window is the period over which the abnormal changes in the merging firms’ stock prices are analyzed. For example, Hazlitt reports the stock price changes over a one day and a three day window. The one day window looks only at the stock prices the day of the merger announcement. The three day window looks at stock price changes from the day before the announcement to the day after the announcement. The longer the window, the greater the chance that other, non-merger, events might be influencing stock prices, thereby undermining the value of any inference about the predicted effects of the merger. The shorter the window, the more compelling becomes the objection that the “market” has had not sufficient time to fully analyze the merger’s effects. Practitioners of the methodology recognize that the conclusions are strongest when similar effects are found using different, reasonable windows.

107. There is an economic literature, some of which is cited by Hazlitt, on the use of stock market event studies to predict the effects of a merger. The goal is to determine whether the market reaction is consistent with one view of a merger and inconsistent with another. We will show that Hazlitt’s results, even if accepted at face value, are in fact of no assistance in distinguishing between the major competing hypotheses on the competitive effects of the Bell Atlantic-GTE merger.

108. In a conventional horizontal merger (where, for example, the merger would reduce the number of competitors from 5 to 4 or 4 to 3) the two competing hypotheses are that the merger will reduce competition by leading to collusion or some other lessening of the intensity of market price competition, or that it will increase competition as the merged company passes through to final customers some of the merger-related efficiencies, thereby making life more difficult for the competition. Event studies can be useful in choosing between these two hypotheses. If investors predict a merger will be pro-competitive, the stock prices of the merging firms should rise, and the prices of competing firms should fall. If investors expect a reduction in the intensity of competition from a merger (e.g., tacit collusion), then the prices of both the merging companies and its rivals should increase.

109. Dr. Hazlitt's event study sheds no light on the expected effects of Bell Atlantic's acquisition of GTE for two reasons. First, the competing theories on whether this merger will enhance or reduce competition are different than the theories for a traditional horizontal merger. To the extent that antitrust enforcement will generally not allow a merger if it will have the effect of permitting unilateral market dominance, horizontal mergers of the type studied in the event study literature cannot lead to predatory or exclusionary behavior. Therefore the sole remaining antitrust issue is whether the merger lessens the intensity of competition between horizontal rivals. But clearly the anticompetitive concern with mergers between major ILECs is not that they will collude with IXCs or other ILECs to raise the price of long distance service and/or bundled services.

110. The competitive danger with both the Bell Atlantic-GTE merger and the SBC-Ameritech merger is that they will increase the ability and/or the incentive of merging companies to engage in exclusionary or predatory behavior, such as discrimination against IXCs in long distance or bundled long distance/local services, or discrimination against local entrants within their service territory, to effectively forestall the development of local competition there. Thus, the observation that the stock prices for AT&T, MCI WorldCom, and Sprint fell with the announcement of the Bell Atlantic-GTE merger is consistent either with the view that the merger is anticompetitive or procompetitive. Investors could expect MCI WorldCom's future prospects were adversely affected by the merger either because it will suffer from increased exclusionary behavior that harms both it and consumers, or that it will suffer from increasing legitimate competition that harms it and helps consumers.^{75/} The event study observation that MCI WorldCom's stock price fell when the merger was announced is thus consistent with both anticompetitive and procompetitive interpretations of the merger, and therefore is of no use in distinguishing between the theories.

111. Second, Hazlitt does not provide the abnormal stock market returns for other parties whose stock valuations should be influenced by the merger. In a proper event study, one looks examines changes in the stock prices of all such firms. The table below lists the abnormal returns, in percentage terms, for a three day window around the Bell Atlantic-GTE merger announcement for several companies of interest that were not covered by Hazlitt.

^{75/} Given that the long distance market is already quite competitive, investor concerns over increased discrimination against MCI WorldCom are more likely than concerns over increased competition.

Cumulative Abnormal Returns (%)

Three Day Window Around Bell Atlantic-GTE Merger Announcement^{76/}

<u>SBC</u>	<u>Ameritech</u>	<u>BSouth</u>	<u>USWest</u>	<u>BA</u>	<u>GTE</u>	<u>BA + GTE</u>
-0.3%	-2.16%	+2.2%	+3.29%	+2.32%	-4.36%	-0.65%

112. If Bell Atlantic and GTE were correct in their belief that the merger generates substantial efficiencies and that the merger will facilitate significant out-of-region entry by the merged company, and if Hazlitt is correct that an event study is appropriate here, then we should observe that:

a) the combined market value of Bell Atlantic and GTE should increase (because of the efficiencies and synergies), and

b) the prices of the other BOCs should be negatively affected because they will be presented with a significant new competitor for local service and bundled services in their regions.

113. In fact, the event study does not support either of these predictions. The combined value of Bell Atlantic and GTE shows negative abnormal returns (-0.65%), indicating that investors

^{76/} None of the qualitative observations we make below would be changed if we used a one-day window.

believe that the merger entails negative synergies (i.e., from the shareholders' perspective, the costs of the merger outweigh the benefits).^{77/}

114. The stock prices of US West and Bell South show positive abnormal returns, which is not what one would expect if the merger were likely to significantly increase local competition in their regions. On the other hand, the stock prices of SBC and Ameritech show negative abnormal returns. It is not likely that investors would expect out-of-region entry by Bell Atlantic-GTE in the SBC and Ameritech regions, but not in the US West and Bell South regions.^{78/} So we need another explanation for the price pattern.

115. The stock price pattern may be explained by a "piling on" phenomenon. This has often happened in antitrust merger reviews. Two companies in an industry announce a merger. Two other competitors then immediately follow with their own merger. The managements for the firms in the second merger may reason that they don't know whether the first merger will get antitrust clearance, but if it does, they want their own merger judged at the same time, expecting that the antitrust authorities will approve both mergers or neither. Something similar may be happening here. SBC and Ameritech probably did not welcome the Bell Atlantic/GTE announcement because it forces the FCC to consider two very large LEC mergers at the same

^{77/} Investors also apparently think that Bell Atlantic struck a good bargain and GTE did not. GTE's abnormal returns were -4.36%. Between the lack of overall synergies from the merger and the bad deal struck by its management, investors think GTE lost almost five per cent of its total value from the merger.

^{78/} Bell Atlantic-GTE had not announced specific entry targets at the time the merger was announced.

time. To the extent the Commission finds the cumulative change in concentration troubling, investors may believe that it is more likely to turn down the first merger than if the second merger were never announced. This could explain why the announcement of Bell Atlantic's acquisition of GTE reduced the stock prices of SBC and Ameritech, but not USWest and BellSouth.

116. Skeptics who may doubt the wisdom of inferring anything from stock price movements are of course free to throw out event studies in their entirety. We believe event studies are one useful tool (among many) for merger analysis, so long as they properly use all the available information to attempt to choose among hypotheses.^{79/}

^{79/} Skeptics are sometimes uncomfortable with event studies because they suspect that if the market quickly knows the economic effects of a merger, it may have anticipated the merger, so the stock price movements on the day of the announcement may reflect only reactions to the financial terms of the merger, and may not be reactions to the merger itself. This does raise serious issues, but they can be addressed within the event study framework. If the merger is anticipated (perhaps because of leaks from financial advisers or from the fact that the merger negotiations are not secret) then the appropriate approach is to lengthen the event window. Abnormal returns can be easily estimated over a much longer period than the one to three day windows Hazlitt employs. With a longer window, the results may become more unreliable to the extent that other important events, affecting the stock prices of the merging companies or their rivals, occur in the window.

We have run the event study including the thirty days prior to the announcement of the merger. The abnormal returns over the period for the IXCs and other BOCs are mixed — MCI and WorldCom had positive returns and AT&T and Sprint had negative returns, some BOCs had positive returns and some had negative returns. We are not confident that other important events affecting valuations for these companies did not occur during the period. In particular, the mixed IXC results may reflect perceptions about the prospects for the then-pending merger of MCI and WorldCom.

Interestingly, however, the abnormal returns were negative (on the order of -10%) for both GTE and Bell Atlantic over the period. If markets were aware of the merger negotiations during this period, and if Bell Atlantic and GTE believe that the Commission should be guided by the implications of event studies, then they should withdraw their merger application. The market is telling them the merger is not in the interests of their shareholders. If Bell Atlantic and

117. In our opinion, a properly interpreted event study, contrary to Hazlitt's claims, indicates investors believe that Bell Atlantic's acquisition of GTE will not result in synergies or efficiencies, and that the merger will not result in significant new, out-of-region local entry. Hazlitt's inference that the IXCs will face consumer-enhancing competition from Bell Atlantic-GTE is not warranted, since the hypothesis that the merger will result in anticompetitive exclusion is equally consistent with the observed changes in stock prices.

VII. SUMMARY AND CONCLUSIONS

118. We have shown here that this merger will not improve consumer welfare and is in fact likely to reduce it. As we noted at the outset, this merger should be evaluated using the learning produced in the aftermath of the Bell Atlantic-NYNEX merger. Even though the Commission believed it was anticompetitive, it approved that merger because of its belief that merger conditions would provide substantial benefits. That merger has not had the intended effects. As we demonstrated in Sections III and IV this merger is also anticompetitive and the Bell Atlantic-GTE local entry argument does not resuscitate it. The prognosis for other mergers among large ILECs is no better.

119. The Bell Atlantic-GTE merger is not in the public interest whether Bell Atlantic-GTE enters local service out of region or not. If Bell Atlantic-GTE decides after the merger not to enter local service out of region, then the public interest approval would have been based on a false premise.

GTE believe that the market really doesn't understand what is going on, they should not present the Commission with event studies to justify their merger.

120. If Bell Atlantic or GTE would have entered each other's territory absent the merger, then the substantial consumer benefits from entry by one ILEC into another ILEC's territory will likely be lost, because local competition is now so poorly developed and one could not presume that other, non-ILEC entrants would replace the competitive effect of the lost out of region entry by GTE or Bell Atlantic in the other merger partner's region.

121. We think it likely, based on our own analysis and GTE's and Bell Atlantic's presentations, that either or both would engage in out of region local entry in the near term as and if facilities-based competition for local business access develops within region. This developing competition creates strong incentives for "defensive" out-of-region entry, to protect their in-region business with major corporate customers. Indeed, unlike Bell Atlantic and NYNEX two years ago, who denied any corporate interest in out-of-region entry, GTE and Bell Atlantic acknowledge that each has a strong interest in out-of-region entry today.

122. If a merged Bell Atlantic-GTE enters out-of-region local markets where neither would have entered as independent companies, it is probably only because they can discriminate more effectively than smaller ILECs to get the business of major business customers.

123. The merger exacerbates the problem of discrimination by Bell Atlantic-GTE to monopolize the emerging Internet and advanced services (such as xDSL). On a stand-alone basis, the discrimination threatens the evolution of local competition in their service territories. If the local operations of Bell Atlantic and GTE are consolidated, the discrimination will also

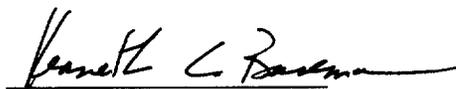
threaten competition on the Internet. Indeed, GTE anticipates its backbone business will benefit from preferential access to Bell Atlantic's customer base.

124. The merger would remove benchmarks that are helpful to regulators as they try to control market power and introduce competition in local telephony.

125. The merger would exacerbate potential competitive problems in the long distance business (assuming ILECs are allowed into interLATA service before local competition has developed).

126. Finally, we have found no compelling reason to believe the merger will allow realization of efficiencies that are not available absent the merger.

We declare under penalty of perjury that the foregoing is true and correct.



Kenneth C. Baseman
Kenneth C. Baseman



A. Daniel Kelley
A. Daniel Kelley

November 23, 1998

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

In the Matter of GTE Corporation, Transferor)
and Bell Atlantic Corporation, Transferee) CC Docket No. 98-184
For Consent to Transfer of Control)

**JOINT DECLARATION
OF MARCEL HENRY AND JOHN TROFIMUK
IN SUPPORT OF COMMENTS OF MCI WORLDCOM, INC.**

We, Marcel Henry and John Trofimuk, declare:

1. We submit this joint declaration in support of the Comments of MCI WORLDCOM, Inc. (“MCI WorldCom”) concerning the proposed merger between Bell Atlantic Corporation (“Bell Atlantic”) and GTE Corporation (“GTE”). The purpose of this Declaration is to discuss the role of benchmarking in negotiating with incumbent local exchange carriers (“ILECs”) and to provide examples of differences between Bell Atlantic and GTE on issues of importance to competitive local exchange carriers (“CLECs”). As described below, each of us has significant knowledge concerning the actions and positions of one of the two companies -- Marcel Henry concerning Bell Atlantic and John Trofimuk concerning GTE.

2. Marcel Henry currently holds the position of Vice President of Financial Operations for MCI WorldCom. His duties in that position include responsibility for negotiating and implementing interconnection arrangements between Bell Atlantic and MCI WorldCom concerning local services, and for managing MCI WorldCom’s relationship with Bell Atlantic as a purchaser of exchange access. Because of his responsibilities, he is familiar with the terms and conditions on which Bell Atlantic is willing to provide interconnection, unbundled network

elements, and services for resale to CLECs, including MCI WorldCom, and the terms and conditions on which it is willing to provide exchange access to interexchange carriers, including MCI WorldCom. The information described below concerning Bell Atlantic is based on Mr. Henry's personal knowledge through direct dealings with representatives of Bell Atlantic and from information learned in the ordinary course of business from colleagues at MCI WorldCom who deal first-hand with representatives of Bell Atlantic.

3. John Trofimuk currently holds the position of Regional Executive for MCI WorldCom. His duties in that position include responsibility for negotiating and implementing interconnection arrangements between GTE and MCI WorldCom concerning local services, and for managing MCI WorldCom's relationship with GTE as a purchaser of exchange access. Because of his responsibilities, he is familiar with the terms and conditions on which GTE is willing to provide interconnection, unbundled network elements, and services for resale to CLECs, including MCI WorldCom, and the terms and conditions on which it is willing to provide exchange access to interexchange carriers, including MCI WorldCom. The information described below concerning GTE is based on Mr. Trofimuk's personal knowledge through direct dealings with representatives of GTE and from information learned in the ordinary course of business from colleagues at MCI WorldCom who deal first-hand with representatives of GTE.

4. Our knowledge is based primarily on our experience in dealing with Bell Atlantic and GTE on behalf of MCI Telecommunications Corporation ("MCI"), which recently became a wholly owned subsidiary of MCI WorldCom. WorldCom may have had some different experiences before it merged with MCI to form MCI WorldCom. When we refer to MCI WorldCom, we include not only the current company but also its predecessors.

BENCHMARKING IN GENERAL

5. In preparation for separate negotiations with Bell Atlantic or GTE, MCI WorldCom routinely analyzes the actions and policies of other ILECs with respect to specific local competition issues. MCI WorldCom can use, and does use, the willingness or ability of one ILEC to provide a service on particular terms and conditions when it bargains with another ILEC for the same arrangement. For example, MCI WorldCom uses its experience with other ILECs when an ILEC claims that it is not technically feasible to provide a service or capability that another ILEC provides to MCI WorldCom, or that a price proposed by MCI WorldCom is unreasonably low even though other ILECs provide the same capability or service at the same price.

6. Benchmarking has proven to be a useful tool not only for federal and state regulators, but also for incumbent LECs' customers to move incumbent LECs toward providing interconnection and access on more reasonable terms and conditions. MCI WorldCom has effectively used benchmarking with Bell Atlantic, GTE and other ILECs not only in its negotiations as a CLEC but also in its negotiations concerning the price and quality of exchange access that they provide to MCI WorldCom as an interexchange carrier. For example, MCI WorldCom has used, and continues to use, the willingness of one ILEC to use a particular system, pricing structure or provisioning process to persuade other ILECs to provide exchange access on the same terms and conditions.

7. MCI WorldCom's ability as a CLEC and as an interexchange carrier to benchmark the different ILECs would be greatly diminished if Bell Atlantic and GTE, or SBC and Ameritech, are permitted to merge. To the extent that Bell Atlantic and GTE take different positions on significant issues for CLECs and interexchange carriers, it is reasonable to expect that they will no longer do so if they are permitted to merge, and that MCI WorldCom's ability to negotiate with ILECs based on positions taken by other ILECs will be reduced.

RECIPROCAL COMPENSATION

8. An example of significantly different policies and practices between Bell Atlantic and GTE involves compensation for exchange of local traffic between ILECs and CLECs. GTE agreed to the approach advocated by MCI – a “bill and keep” system under which both sides receive and complete local calls intended for their subscribers, without any exchange of money.

9. In contrast, Bell Atlantic rejected a bill and keep approach in favor of a system of reciprocal compensation. Notwithstanding Bell Atlantic’s preference for reciprocal compensation, however, Bell Atlantic has subsequently refused to pay the required compensation for local traffic that MCI WorldCom terminates to Internet Service Providers, and MCI WorldCom has been forced to obtain orders from state commissions requiring Bell Atlantic to comply with its obligations.

10. At a minimum, the different approaches of GTE and Bell Atlantic provide information about the practical effects so that competitors and regulators can evaluate which system is best.

OPERATIONS SUPPORT SYSTEMS FOR MAINTENANCE

11. As is the case with most ILECs, Bell Atlantic operates an electronic system to receive, track and process “trouble tickets” reporting problems in Bell Atlantic’s provision of local interconnection access to CLECs. Although the system is not without problems, it at least allows a CLEC such as MCI WorldCom to seek to resolve problems in a relatively efficient manner.

12. In contrast, GTE lacks any electronic system to handle problem reports concerning the local interconnection and access it provides to CLECs such as MCI WorldCom. Thus, to report a problem and seek a resolution of the problem, MCI WorldCom’s operations staff must attempt to reach GTE’s operations department by telephone. The resulting system leads to delays and inefficiencies in the resolution of problems.

ACCOUNT TEAM SUPPORT

13. GTE has committed more resources than Bell Atlantic to account team support for MCI WorldCom (although MCI WorldCom still does not always get satisfactory and timely resolution of issues with GTE). GTE has dedicated more than twenty individuals to address issues that arise with MCI WorldCom both as a CLEC and as an interexchange carrier that purchases exchange access from GTE.

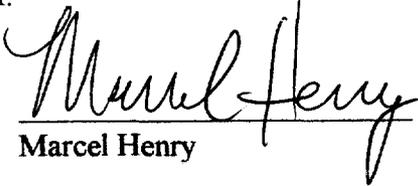
14. In marked contrast, the number of Bell Atlantic personnel responsible for working with MCI WorldCom is less than half the number dedicated by GTE, even though MCI WorldCom is at least as important a customer of Bell Atlantic as of GTE. Moreover, Bell Atlantic allocates, for its entire region, a grand total of *three* individuals to work with MCI WorldCom on issues relating to MCI WorldCom's efforts as a CLEC to compete with Bell Atlantic. Bell Atlantic's lower staff commitment has lead, at a minimum, to unjustified delays in the resolution of business issues between the two companies including, including for example, the processing of orders and development of efficient systems.

15. Beyond the staffing levels themselves, Bell Atlantic has divided its few support staff members into two groups -- one for exchange access service and one for CLEC issues -- and refuses to permit MCI WorldCom to work with a single support group, even on issues that involve both access and CLEC aspects. This splitting of support functions significantly complicates MCI WorldCom's ability to solve problems with Bell Atlantic.

16. In addition, MCI WorldCom has information that Bell Atlantic has already made clear to GTE that after a merger of the two companies, the merged company will reduce the level of staffing provided to support its business relationship with MCI WorldCom.

We declare under penalty of perjury that the foregoing is true and correct.

I, Marcel Henry, hereby attest and state that the statements contained herein are true and correct to the best of my knowledge, information and belief.


Marcel Henry

Subscribed and sworn to before me this 23^d day of November, 1998.


(signature of notary)

My commission expires:

May 14, 2000
(appropriate date)

I, John Trofimuk, hereby attest and state that the statements contained herein are true and correct to the best of my knowledge, information and belief.


John Trofimuk

Subscribed and sworn to before me this 20th day of November, 1998.


(signature of notary)

My commission expires:

8/29/99
(appropriate date)





GTE Corp.

Company Update

Guy W. Woodlief (212) 778-8411
Michael D. Carruthers (212) 778-2643

Rating: Hold (Low Risk)

- Operating results in line with expectations.
- Core telco EPS growth of 10%.
- Dilution from data initiatives of \$0.10
- 40% cellular EBITDA margin.

GTE (58 3/4)– NYSE

October 27, 1998

	Earnings Per Share Fiscal Year Ending			P/E 12/99E	Ind. Div.	Yield	Shares O/S (Mil.)	52 Wk Ran
	12/97	12/98E	12/99E					
New	\$2.90	\$3.07	\$3.50	16.8X	\$1.88	3.2%	968	64-
Old		3.05						
DJIA:	8366.04							
S&P 500:	1065.35							

Priced as of the close, October 27, 1998

GTE Reports 3Q98 EPS Of \$0.85 Versus Our \$0.84 Estimate: Operating Results In Line; Raising 1998 EPS Estimate To \$3.07 From \$3.05

Highlights

- GTE reported 3Q98 recurring EPS of \$0.85 versus our \$0.84 estimate and \$0.79 in the year-ago period.
- EPS from the core telco were \$0.95, in line with our \$0.95 estimate, and dilution from new data initiatives was \$0.10 versus our \$0.11 estimate.
- We are increasing our 1998 estimate to \$3.07 from \$3.05, which reflects an estimate of \$0.88 in 4Q98, consisting of \$0.98 from core operations (10% growth) and \$0.10 dilution from data initiatives. We are maintaining our 1999 estimate of \$3.50 with some minor changes in the quarterly progression, which reflects about 10% growth in the core in each quarter offset by dilution from data initiatives of \$0.10 in 1Q99, \$0.09 in 2Q99, \$0.09 in 3Q99, and \$0.08 in 4Q99.
- Volume and revenue growth at the core telco were strong. Switched access line growth was 5.3% versus our 5.3% estimate; interstate access MOU growth was 8.1% versus our 7.5% estimate; intrastate access MOU growth was 18% versus our 18% estimate; revenue growth was 8%.
- In the domestic cellular business GTE continued its focus on slower but more profitable growth. Domestic cellular subscriber net adds were 54,000, the ARPU remained flat sequentially at \$49, and the EBITDA margin increased to 40% versus 36% in the year-ago period.



- GTE added 272,000 interLATA long distance customers to reach a total of 2.516 million.
- Competitive activity remained modest, as evidenced by strong business switched access line growth of 9.7% and total resold lines of only 102,000 (40% of which were to GTE's own CLEC operations).

Investment Opinion

GTE plans to merge with Bell Atlantic (BEL, 49 9/16, rated Strong Buy) in a transaction in which GTE shareholders are to receive 1.22 shares of Bell Atlantic for each GTE share. Based on this exchange ratio, the spread between GTE and Bell Atlantic is currently 7%. Given that we expect thorough regulatory scrutiny of this proposed merger to result in it closing as late as the end of 1999, we don't believe that a 7% spread is large enough to warrant more than a Hold rating on GTE at this time.

Additional Information

GTE reported diluted EPS of \$0.85 versus our \$0.84 estimate and \$0.79 in the year-ago period. Earnings from the core business were \$0.95 versus our \$0.95 estimate and dilution from new data initiatives was \$0.10 versus our \$0.11 estimate. We expect 10% earning growth from core operations in 4Q98 and \$0.10 dilution from data initiatives, leading to an estimate of \$0.88 in 4Q98. This increases our 1998 EPS estimate to \$3.07 from \$3.05. We are maintaining our 1999 EPS estimate of \$3.50.

GTE's Domestic Wireless EBITDA Remains At About 40%. Throughout this year, GTE has endeavored to strike profitable balance between subscriber growth and profitability in a wireless environment characterized by higher churn due to greater competition. In the third quarter, GTE continued its execution of this strategy with an EBITDA margin of 39.6% versus 35.7% in the year-ago period and 39.3% in the second quarter. Gross additions rose to 426,000 in the third quarter versus 403,000 in the second quarter, but a churn rate of 2.5% versus 2.3% in the second quarter resulted in net additions of 54,000. ARPU dropped modestly to \$49 from \$51 in the year-ago period and remained flat sequentially.

Most of the RBOCs are following similar strategies of focusing on high-value customers at the expense of some subscriber growth and are achieving EBITDA margins in the 45% to 50% range (with the exception of Ameritech (AIT, 49, rated Strong Buy)), whose EBITDA margin is running at about 40% due to intense pricing competition in its region). We think it may be difficult for GTE to drive its EBITDA margin much above 40% because of its competitive position in an environment in which national reach is increasingly important. Given its fragmented wireless territories, GTE will most likely have to pay out relatively high amounts of roaming charges to other carriers if it ends up matching national offers from the likes of AT&T with no additional charges for roaming or for long distance. GTE is always trying to negotiate better roaming rates with other carriers, but even a low roaming rate will be a competitive disadvantage versus carriers with national reach. Obviously, the merger with Bell Atlantic, if consummated, will address this competitive issue to a large extent. In the meantime, GTE plans to fight to keep its high-value customers. GTE has not matched AT&T's Digital OneRate plan yet, but plans on contacting one-third of its customers whom it considers to be high-value and offering them more attractive pricing plans.

We believe that GTE should be able to maintain a wireless EBITDA margin in the high 30's in the fourth quarter. Acquisition cost per gross addition in 3Q98 was \$300 versus \$324 in the second quarter. We believe there could be room for GTE to reduce that number further as a result of declining handset prices and ongoing cost reduction measures such as distribution channel rationalization.

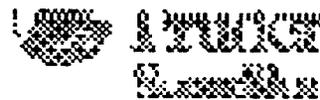
Consolidated Revenues Grew 9.1% Versus Our 10.0% Estimate. Adjusted for an unfavorable currency translation related to GTE's Canadian operations, revenue growth would have been in line with our estimate. Revenue growth in **local services** was 6.9% versus our 8.0% estimate. Switched access lines growth continued to be strong at 5.3% versus our 5.3%

estimate and special access line growth was 22.3%, resulting in total access line growth of 7.7%. Residential access line growth was 3.6% and business access line growth was 9.7%. Of the \$113 million increase in local services revenues, about \$93 million was domestic and \$20 million was international. Of the domestic increase, about \$20 million was due to vertical services, which still have a lot of room to grow. Caller ID penetration was 17.6%; Voicemail penetration was 8%; and Call Waiting penetration was 38%. **Interstate access revenues** grew 5.5% versus our 3.9% estimate. Interstate access MOU grew 8.1% versus our 7.5% estimate. **Intrastate access** revenues grew 5.6% versus our 3.9% estimate and despite intrastate access MOU growth of 18% (due in part to the loss of intraLATA toll minutes to competition, which generates intrastate access MOU for GTE) versus our 18% estimate. Taking interstate and intrastate access revenues together, the increase was \$66 million versus the year-ago period. About two thirds of the increase was due to growth in special access services. Special access lines grew 22.3% and special access revenue was \$136 million in the quarter, about 10% of access revenues. Price reductions in the quarter netted to about \$90 million when both per-minute price declines and increased flat charges are considered. **Toll services** revenue declined 5.7% versus our estimate of a 5.6% decline. GTE's market share of intraLATA toll is now about 50% and seems to be leveling off, similar to the experience of several RBOCs in regions in which they have faced "1+" competition for some time. In the interLATA toll business GTE continues to sign up customers quickly. GTE added 272,000 (versus 209,000 in the second quarter) interLATA toll customers to reach a total of over 2.5 million. InterLATA long distance revenue was an estimated \$160 million in the quarter. Average revenue per interLATA long distance customer was about \$23 per month, in line with our expectations. The interLATA long distance customer mix continues to be about 90% residential and 10% business. **Other services and sales** revenue growth was a strong 19.5%, but down from growth rates in excess of 30% in the first two quarters. This line item's growth rate can fluctuate significantly because it includes a variety of businesses, some of which have "choppy" revenue recognition. The largest example of this is GTE's government systems business, which had revenue growth of about \$47 million in the second quarter of this year versus the year-ago period but revenue growth of only about \$17 million in the third quarter versus the year-ago period.

GTE's **data initiatives** are included in Other services and sales and continued to grow quickly, with revenue of \$202 million of revenue in the quarter, a 60% increase versus the year-ago period. Growth in data initiatives revenues represented about 15% of overall GTE revenue growth. Adjusted for several items which slowed the overall growth of this category (such as declining AT&T contract), revenue growth in GTE's "core" Internet businesses was closer to 80%.

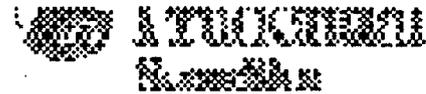
GTE's Operating Margin Was 25.5% Versus Our 25.1% Estimate. Consolidated operating income grew 11.0%, yet operating income at the domestic wireline business grew only 1.3%. By backing out from consolidated results the results of the domestic wireline business, the domestic wireless business, and the data initiatives we deduced that the operating margin on the remaining businesses – primarily the international and directory businesses – increased from 21% to 29%. In order for GTE to meet our 1999 EPS estimate of \$3.50, the domestic wireline business will obviously have to contribute significantly more to operating income growth. We believe that the domestic wireline operating income margin has been temporarily depressed over the last two quarters due to spending by GTE to establish a national sales, service, and marketing organization to be leveraged by its CLEC going forward.

Expenses Grew 8.5% Versus Our 9.9% Estimate. **Costs of services and sales** grew 13.3% versus our 20.4% estimate, but that favorable comparison was partially offset by SG&A expense growth of 8.1% versus our estimate of a 1.4% decline. In general, those two expenses categories taken together should increase more slowly as dilution from GTE's data initiatives declines. We estimate that dilution from GTE's data initiatives will decline gradually from \$0.10 in 4Q98 to zero in the second half of 2000. We also estimate that interLATA long distance will be dilutive through the end of 1998 and for all of 1999 before turning positive in 2000. **Depreciation and amortization** expense declined 2.5% as a result of asset retirements that were part of the one-time charges announced in April of this year and as a result of accounting changes at GTE's Canadian operations.



GTE's ADSL Plans Are On Track. GTE has equipped 200 central offices (COs) with ADSL and has an initial contract in place with Microsoft (MSFT, not rated) for 500 units. GTE also has resale agreements in place with 46 ISPs. GTE plans to make ADSL available to six million of its customers by the end of this year, bringing the total COs to 300. GTE's offerings include 5 service packages with downstream speeds ranging from 258 kilobits per second to 1.5 megabits per second.

Competitive Activity Remains Modest In GTE's Regions. We have always expected GTE to come under competitive pressure in its local exchange business at a slower rate than the industry as a whole due to the fact that up to 90% of its access lines could be defined as rural. An important determinant of a CLEC's business plan is density of access lines, since a dense access line configuration allows for very efficient capital deployment. GTE's ILEC ended 3Q98 with 102,000 resold lines, a modest increase from 83,000 at the end of the second quarter. About 40% of the 102,000, however, are being resold by GTE's own CLEC. GTE's out-of-region CLEC activities are proceeding very slowly as the company awaits regulatory clarity in the industry. GTE is not alone in this approach. Given current resale discounts, we have seen many would-be resellers abandon that approach and go back to the drawing board.



GTE
A TRUCKEE
NEW YORK

Figure 1 . GTE Quarterly Income Statement

(\$Millions)

	<u>1Q97</u>	<u>2Q97</u>	<u>3Q97</u>	<u>4Q97</u>	<u>1Q98</u>	<u>2Q98</u>	<u>3Q98E</u>	<u>4Q98E</u>
Revenues and Sales								
Local services	1,605	1,613	1,647	1,742	1,730	1,771	1,760	1,873
Network access services								
Interstate	728	794	788	748	841	810	829	783
Intrastate	424	466	483	492	485	480	508	517
Toll services	643	608	609	569	591	572	574	538
Cellular services	677	719	714	707	718	745	770	745
Directory services	186	372	407	542	195	379	495	564
Other services and sales	1,018	1,120	1,292	1,547	1,325	1,520	1,544	1,916
Total revenues and sales	5,281	5,692	5,940	6,347	5,885	6,277	6,480	6,935
Operating Costs and Expenses								
Cost of services and sales	1,952	2,194	2,309	2,748	2,498	2,671	2,617	2,967
Selling, general and administrative	1,027	1,115	1,156	1,262	1,071	1,231	1,250	1,357
Depreciation and amortization	956	977	988	965	969	943	963	988
Total operating expenses	3,935	4,286	4,453	4,975	4,538	4,845	4,830	5,311
Operating Income	1,346	1,406	1,487	1,372	1,347	1,432	1,650	1,624
Interest expense - net	275	289	299	282	289	311	312	308
Other expense - net	20	20	(12)	20	23	21	10	10
Income before income taxes	1,051	1,097	1,200	1,070	1,035	1,100	1,328	1,306
Income taxes	386	426	444	368	411	427	506	449
Net Income before Nonrecurring Items	665	671	756	702	624	673	822	857
Nonrecurring Items	0	0	0	0	(802)	0	0	0
Net Income as Reported	665	671	756	702	(178)	673	822	857
Diluted Earnings Per Share (Recurring)	\$0.00	\$0.00	\$0.00	\$0.73	\$0.65	\$0.69	\$0.85	\$0.88
-- Growth				-10.2%				21.4%
-- Average Common Shares Outstanding	0	0	0	963	968	972	968	968
Basic Earnings Per Share (Recurring)	\$0.69	\$0.70	\$0.79	\$0.73	#	\$0.65	\$0.70	\$0.85
-- Growth	11.1%	6.3%	0.9%	-9.9%	#	-6.1%	-0.3%	7.8%
-- Average Common Shares Outstanding	960	956	956	957	0	959	962	964

Source: Company reports and Prudential Securities estimates.

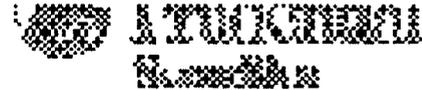


Figure 2. GTE Income Statement
(\$Millions)

	1994	1995	1996	1997	1998E	1999E	2000E	2001E	2002E
Revenues and Sales									
Local services	5,234	5,839	6,155	6,607	7,134	7,661	8,197	8,763	9,364
Network access services									
Interstate	2,722	2,741	2,917	3,058	3,263	3,386	3,462	3,523	3,568
Intrastate	1,626	1,622	1,701	1,865	1,990	2,075	2,156	2,214	2,264
Toll services	3,285	2,548	2,500	2,429	2,275	2,383	2,447	2,502	2,558
Cellular services	1,666	2,191	2,562	2,817	2,978	3,101	3,230	3,366	3,507
Directory services	1,372	1,383	1,527	1,507	1,633	1,715	1,801	1,891	1,986
Other services and sales	3,623	3,633	3,977	4,977	6,305	8,073	10,140	12,511	14,923
Total revenues and sales	19,528	19,957	21,339	23,260	25,577	28,395	31,433	34,769	38,170
Operating Costs and Expenses									
Cost of services and sales	7,677	7,537	8,071	9,203	10,753	11,944	13,257	14,720	16,205
Selling, general and administrative	3,667	3,689	4,010	4,560	4,909	5,461	6,121	6,867	7,581
Depreciation and amortization	3,432	3,675	3,770	3,886	3,863	4,277	4,707	5,111	5,541
Total operating expenses	14,776	14,901	15,851	17,649	19,524	21,683	24,085	26,698	29,326
Operating Income	4,752	5,056	5,488	5,611	6,053	6,713	7,348	8,071	8,843
Interest expense - net	1,059	1,047	1,026	1,145	1,220	1,215	1,194	1,122	997
Other expense - net	(16)	5	62	48	64	65	66	68	69
Income before income taxes	3,709	4,004	4,400	4,418	4,769	5,433	6,088	6,881	7,777
Income taxes	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Income taxes	1,430	1,466	1,610	1,624	1,793	2,044	2,258	2,554	2,888
Net Income before Nonrecurring Items	2,279	2,538	2,790	2,794	2,976	3,389	3,830	4,327	4,889
Nonrecurring Items	162	(4,682)	8	0	(802)	0	0	0	0
Net Income as Reported	2,441	(2,144)	2,798	2,794	2,174	3,389	3,830	4,327	4,889
Diluted Earnings Per Share (Recurring)	\$0.00	\$0.00	\$2.87	\$2.90	\$3.07	\$3.50	\$3.95	\$4.47	\$5.05
-- Growth	0.0%	0.0%	0.0%	1.2%	5.7%	13.9%	13.0%	13.0%	13.0%
-- Average Common Shares Outstanding	0	0	972	962	969	969	969	969	969
Basic Earnings Per Share (Recurring)	\$2.38	\$2.62	\$2.88	\$2.92	\$3.09	\$3.52	\$3.98	\$4.50	\$5.08
-- Growth	0.0%	10.0%	10.0%	1.3%	6.0%	13.9%	13.0%	13.0%	13.0%
-- Average Common Shares Outstanding	958	970	969	958	962	962	962	962	962

Source: Company reports and Prudential Securities estimates.

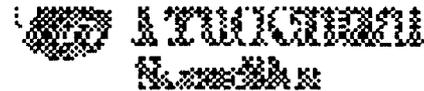


Figure 3. GTE Revenue, Margin, and Profitability Analysis

	1994	1995	1996	1997E	1998E	1999E	2000E	2001E	2002E
Operating Revenue Growth:									
Local services		11.6%	5.4%	7.3%	8.0%	7.4%	7.0%	6.9%	6.9%
Network access services									
Interstate		0.7%	6.4%	4.8%	6.7%	3.8%	2.2%	1.8%	1.3%
Intrastate		-0.2%	4.9%	9.6%	6.7%	4.3%	3.9%	2.7%	2.3%
Toll services		-22.4%	-1.9%	-2.8%	-6.3%	4.7%	2.7%	2.2%	2.3%
Cellular services		31.5%	16.9%	10.0%	5.7%	4.1%	4.1%	4.2%	4.2%
Directory services		0.8%	10.4%	-1.3%	8.4%	5.0%	5.0%	5.0%	5.0%
Other services and sales		0.3%	9.5%	25.1%	26.7%	28.1%	25.6%	23.4%	19.3%
Total revenues and sales		2.2%	6.9%	9.0%	10.0%	11.0%	10.7%	10.6%	9.8%
Operating Expense Growth:									
Cost of services and sales		-1.8%	7.1%	14.0%	16.8%	11.1%	11.0%	11.0%	10.1%
Selling, general and administrative		0.6%	8.7%	13.7%	7.6%	11.3%	12.1%	12.2%	10.4%
Depreciation and amortization		7.1%	2.6%	3.1%	-0.6%	10.7%	10.0%	8.6%	8.4%
Total operating expenses		0.8%	6.4%	11.3%	10.6%	11.1%	11.1%	10.9%	9.8%
Operating Margin	24.3%	25.3%	25.7%	24.1%	23.7%	23.6%	23.4%	23.2%	23.2%
Pre-tax Margin	19.0%	20.1%	20.6%	19.0%	18.6%	19.1%	19.4%	19.8%	20.4%
Tax Rate	38.6%	36.6%	36.6%	36.8%	37.6%	37.6%	37.1%	37.1%	37.1%
Net Margin - Recurring	11.7%	12.7%	13.1%	12.0%	11.6%	11.9%	12.2%	12.4%	12.8%
Profitability Analysis:									
Net Margin	11.7%	12.7%	13.1%	12.0%	11.6%	11.9%	12.2%	12.4%	12.8%
x Asset Turnover	0.55	0.50	0.57	0.59	0.60	0.62	0.64	0.66	0.68
= Return on Assets	6.4%	6.4%	7.4%	7.0%	7.0%	7.4%	7.8%	8.2%	8.8%
x Financial Leverage	6.82	4.58	5.31	5.08	5.04	4.93	4.51	4.05	3.60
= Return on Equity	43.5%	29.2%	39.3%	35.8%	35.4%	36.6%	35.1%	33.4%	31.6%
Memo:									
EOP Employees	111,000	106,000	102,000	114,000	115,140	116,291	117,454	118,629	119,815
-- Growth		-4.5%	-3.8%	11.8%	1.0%	1.0%	1.0%	1.0%	1.0%

Source: Company reports and Prudential Securities estimates.

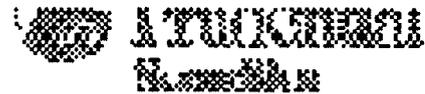
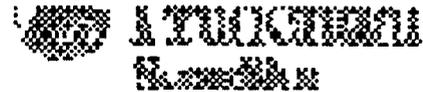


Figure 4. GTE U.S. Cellular Operations

	1994	1995	1996	1997	1998E	1999E	2000E	2001E	2002E
U.S. Cellular									
Service revenues	1,539	2,019	2,347	2,549	2,640	2,687	2,732	2,774	2,815
Equipment sales and other	129	129	134	193	218	243	268	293	318
Total revenues and sales	1,668	2,148	2,481	2,742	2,858	2,930	3,000	3,067	3,133
-- Growth	41.1%	28.8%	15.5%	10.5%	4.2%	2.5%	2.4%	2.3%	2.1%
Depreciation and Amortization	265	332	385	405	429	437	444	451	457
Other Operating Expenses	1,125	1,406	1,635	1,888	1,929	1,975	2,019	2,061	2,102
Operating Income	278	410	461	449	500	519	537	555	573
Operating Cash Flow (EBITDA)	543	742	846	854	929	955	981	1,006	1,031
Capex	(610)	(709)	(600)	(297)	(250)	(225)	(200)	(200)	(200)
Margin Analysis (% of Total revenues):									
Depreciation and Amortization		15.5%	15.5%	14.8%	15.0%	14.9%	14.8%	14.7%	14.6%
Other Operating Expenses		65.5%	65.9%	68.9%	67.5%	67.4%	67.3%	67.2%	67.1%
Operating Income		19.1%	18.6%	16.4%	17.5%	17.7%	17.9%	18.1%	18.3%
Operating Cash Flow (EBITDA)	35.3%	36.8%	36.0%	33.5%	36.0%	38.0%	39.0%	40.0%	40.0%
Capex		33.0%	24.2%	10.8%	8.7%	7.7%	6.7%	6.5%	6.4%
Operating Statistics:									
Adjusted POPs (000s)	53,000	61,700	61,900	61,900	61,900	61,900	61,900	61,900	61,900
Subscribers (000s)	2,339	3,011	3,749	4,487	4,743	5,027	5,324	5,633	5,954
-- Growth									
Gross Adds			1,773	1,869	1,565	1,672	1,766	1,863	1,964
Disconnects due to Churn			1,035	1,131	1,309	1,388	1,469	1,555	1,643
Net Adds	754	672	738	738	256	285	297	309	321
-- Growth		-10.9%	9.8%	0.0%	-65.3%	11.3%	4.2%	4.1%	4.0%
Churn per month		0.0%	2.3%	2.1%	2.3%	2.3%	2.3%	2.3%	2.3%
Penetration (% of adjusted POPs)		4.9%	6.1%	7.2%	7.7%	8.1%	8.6%	9.1%	9.6%
Service revenue per sub per month	\$68	\$63	\$60	\$51	\$50	\$48	\$46	\$44	\$42
Change	-4.2%	-7.4%	-4.8%	-15.0%	-2.0%	-4.0%	-4.0%	-4.0%	-4.0%
U.S. PCS									
POP's				9,697	9,697	9,697	9,697	9,697	9,697
Subscribers				19	56	84	118	153	184
-- Growth				0	2	1	0	0	0
Revenue per sub per month				\$51	\$50	\$48	\$46	\$44	\$42
Revenue				6	22	40	56	72	86
GTE Domestic Subscriber Growth Including both Cellular and PCS					6.5%	6.5%	6.5%	6.3%	6.1%
Source: Company reports and Prudential Securities estimates.									



GTE
TELEPHONE
COMPANY

Figure 5. GTE Balance Sheet

(\$ Millions)

	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997E</u>	<u>1998E</u>	<u>1999E</u>	<u>2000E</u>	<u>2001E</u>	<u>2002E</u>
ASSETS									
Current Assets									
Cash	323	332	405	256	202	464	847	1,151	1,561
Accounts receivable	4,022	4,227	4,482	4,885	5,372	5,964	6,602	7,303	8,017
Inventories and supplies	676	719	673	734	807	896	991	1,097	1,204
Prepaid and other	613	614	473	516	567	629	697	771	846
Total Current	5,634	5,892	6,033	6,391	6,948	7,953	9,137	10,321	11,628
Net PP&E	29,328	22,437	22,902	24,144	25,687	26,897	27,782	28,394	28,714
Other L-T Assets	7,538	8,690	9,487	10,341	11,371	12,624	13,975	15,458	16,970
Total Assets	42,500	37,019	38,422	40,876	44,006	47,474	50,893	54,173	57,312
LIABILITIES & EQUITY									
Current Liabilities									
S-T Debt	2,042	2,156	2,497	2,622	2,622	2,622	2,622	2,622	2,622
Accounts Payable	4,010	3,858	4,156	4,530	4,981	5,530	6,122	6,772	7,434
Other	2,169	2,298	1,661	1,811	1,991	2,210	2,447	2,706	2,971
Total Current	8,221	8,312	8,314	8,963	9,594	10,363	11,191	12,100	13,027
L-T Debt	12,163	12,744	13,210	13,210	14,400	14,400	13,800	12,400	10,300
Employee Benefit Obligations	4,651	4,638	4,688	5,110	5,619	6,238	6,906	7,638	8,386
Deferred taxes, credits and other	6,982	4,454	4,874	5,313	5,842	6,486	7,180	7,941	8,718
Equity	10,483	6,871	7,336	8,281	8,550	9,988	11,817	14,094	16,881
Total Liabilities & Equity	42,500	37,019	38,422	40,876	44,006	47,474	50,893	54,173	57,312

Source: Company reports and Prudential Securities estimates.

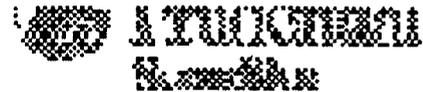


Figure 6. GTE Corporation Cash Flow Statement

(\$Millions)	1994	1995	1996	1997	1998E	1999E	2000E	2001E	2002E
Net Income	2,441	(2,144)	2,798	2,794	2,174	3,389	3,830	4,327	4,889
Depreciation & Amortization	3,432	3,675	3,770	3,886	3,863	4,277	4,707	5,111	5,541
Other	(1,133)	3,502	(669)	674	29	35	38	41	42
Net Cash Provided by Operating Activities	4,740	5,033	5,899	7,354	6,065	7,701	8,574	9,479	10,472
Capex - U.S. Telephone	(2,821)	(2,564)	(2,690)	(3,607)	(3,643)	(3,825)	(3,940)	(4,058)	(4,180)
Capex - U.S. Cellular	(610)	(709)	(600)	(297)	(250)	(225)	(200)	(200)	(200)
Capex - Other operating units and corporate	(761)	(761)	(798)	(1,224)	(1,513)	(1,437)	(1,452)	(1,466)	(1,481)
Total Capital Expenditures	(4,192)	(4,034)	(4,088)	(5,128)	(5,406)	(5,487)	(5,592)	(5,724)	(5,861)
Acquisitions and investments	(244)	(798)	(476)	(650)	0	0	0	0	0
Other	1,167	331	287	0	0	0	0	0	0
Net Cash Used in Investing Activities	(3,269)	(4,501)	(4,277)	(5,778)	(5,406)	(5,487)	(5,592)	(5,724)	(5,861)
Dividends Paid	(1,806)	(1,827)	(1,825)	(1,849)	(1,904)	(1,952)	(2,000)	(2,050)	(2,102)
Proceeds from Sale of Common Stock	422	385	444	0	0	0	0	0	0
Purchase of Common Stock for Treasury	0	(133)	(967)	0	0	0	0	0	0
Other	(86)	1,052	799	125	1,190	0	(600)	(1,400)	(2,100)
Net Cash Used in Financing Activities	(1,470)	(523)	(1,549)	(1,724)	(714)	(1,952)	(2,600)	(3,450)	(4,202)
Increase (Decrease) in Cash	1	9	73	(149)	(55)	262	383	305	410
EBITDA	8,184	8,731	9,258	9,497	9,916	10,990	12,055	13,182	14,384
EBITDA as a % of Sales	41.9%	43.7%	43.4%	40.8%	38.8%	38.7%	38.4%	37.9%	37.7%
Free Cash Flow	(125)	(4,330)	655	(297)	(1,273)	227	945	1,663	2,468

Source: Company reports and Prudential Securities estimates.

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20 October 1998

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GTE Corp

3Q Results In Line; Strong Core Continues to Drive Accelerating EPS Growth
Reason for Report: Third Quarter Earnings Reported
ACCUMULATE*
Long Term ACCUMULATE

Price:	\$56 3/4		
Estimates (Dec)	1997A	1998E	1999E
EPS:	\$2.92	\$3.05	\$3.50
P/E:	19.4x	18.6x	16.2x
EPS Change (YoY):		4.5%	14.8%
Consensus EPS:		\$3.06	\$3.48
(First Call: 16-Oct-1998)			
Q3 EPS (Sep):	\$0.79	\$0.85	
Cash Flow/Share:	\$6.95	\$7.03	\$7.67
Price/Cash Flow:	8.2x	8.1x	7.5x
Dividend Rate:	\$1.82	\$1.88	\$1.88
Dividend Yield:	3.2%	3.3%	3.3%

Opinion & Financial Data

Investment Opinion:	B-2-2-7
Mkt. Value / Shares Outstanding (mn):	\$54,990 / 969
Book Value/Share (Jun-1998):	\$8.12
Price/Book Ratio:	7.0x
ROE 1998E Average:	NA
LT Liability % of Capital:	65.8%
Est. 5 Year EPS Growth:	11.5%

Stock Data

52-Week Range:	\$64 3/8-\$40 1/2
Symbol / Exchange:	GTE / NYSE
Options:	AMEX
Institutional Ownership-Spectrum:	41.9%
Brokers Covering (First Call):	20

ML Industry Weightings & Ratings**

Strategy; Weighting Rel. to Mkt.:		
Income:	Overweight	(07-Mar-1995)
Growth:	Underweight	(07-Mar-1995)
Income & Growth:	Overweight	(07-Mar-1995)
Capital Appreciation:	In Line	(30-Jun-1998)
Market Analysis; Technical Rating:	Average	(27-Jul-1998)

*Intermediate term opinion last changed on 31-Jul-1998.

**The views expressed are those of the macro department and do not necessarily coincide with those of the Fundamental analyst.

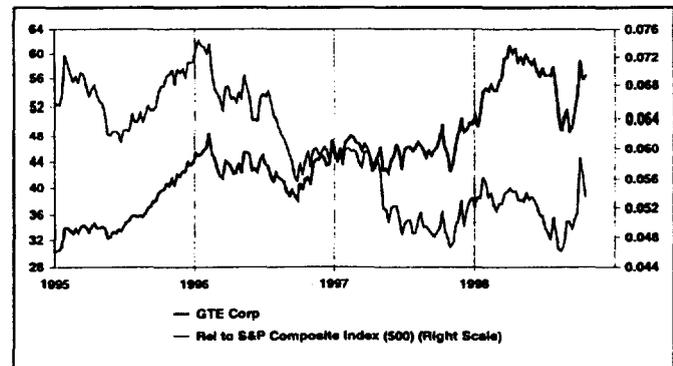
For full investment opinion definitions, see footnotes.

Investment Highlights:

- We continue to rate GTE Shares Accumulate. With GTE trading at a 7% discount to the merger exchange ratio with BEL, we see 35% upside over the next 12-18 months given the 1.22 exchange ratio applied to our BEL target price of \$62 — based on targeted relative P/E of 90%.
- We expect EPS growth to accelerate to 10% in 4Q and to 15% in '99 due to expanding data, CLEC and LD contributions. No changes to our EPS ests. of \$3.05 in '98 and \$3.50 in '99.

Fundamental Highlights:

- EPS were 85¢ (up 7.6% y/y), in line with our est. and a penny better than First Call consensus. After excluding the start-up expenses associated with all new initiatives, core operating income and EPS would have increased by approx. 15%.
- Normalized for currency exchange rate conversions and a directory publishing shift, revenues rose approx. 9% vs. our 12% est. However, operating expense growth rose only 8.5% vs. our 11.9% est. leading to a solid 11% increase in operating income.
- Strong growth in data revs (+48%), switched access lines (+5.3%), dedicated lines (+22.3%), LD revs (+66%), and enhanced services (+28%). Domestic wireless remained soft with 7% revenue growth (which was actually better than our 5% estimate) and 9.1% subscriber growth.

Stock Performance


Third Quarter Review:

GTE reported 3Q EPS of 85¢, up 7.6% from 3Q97's 79¢. The results were in line with our estimate but a penny higher than First Call's consensus. Though puzzled by a slowdown in other service and sales revenue and continued softness in its wireless results, we view GTE's 3Q results as solid reflecting EPS growth acceleration from 2Q's 1.4% decline. Data initiatives lowered GTE's EPS by 10¢ per share vs. 7¢ per share reported a year-ago and the 11¢ in 3Q. In addition, we estimate that costs associated with the rollout of PCS, long distance and CLEC businesses further diluted EPS by almost 10¢ (vs. about 5¢ in 3Q97). **We estimate, after excluding the start-up expenses associated with all new initiatives, core operating income and EPS would have increased by approximately 15% y/y.**

Reported revenue growth was 9.1% y/y, hurt by the impact of Canadian currency exchange rate conversions (-\$64M) and helped by a directory publishing shift (+65M). However, after adjusting for the currency exchange rate conversions and the directory publishing shift, **we estimate total revenue growth was 9%, below our estimate of 12% and 2Q's 10.3% rise.** On a reported basis, local service revenues rose 7% y/y. After normalizing for the exchange rate conversion, we estimate local service revenues increased almost 9% y/y, a deceleration from our forecasted and 2Q's 9.8% rise. Access revenues rose 5.2% in the quarter, up from 2.5% in 2Q and in line with our estimate. Strong demand in access minutes (+12% y/y) and dedicated access lines (+22.3%) was offset by a mandated \$90M (net of SLC and PICC receipts) reduction in access rates. Strong growth in data revenues, drove "other services and sales" growth of almost 20% vs. 2Q's 36% rise and our 30% estimate. We believe the deceleration is mainly due to a slowdown in the roll-out of the out-of-region CLEC, a good thing since we've long viewed out-of-region CLEC efforts as costly, risky and unnecessary given the strength of in-region opportunities.

Domestic wireline revenue grew 8.1%, up from 2Q's 7.7% increase. Switched access lines increased 5.3% which were in line with our estimate but an acceleration from 5% in 2Q. Residential and business switched line growth was 3.3% and 9.7%, respectively (vs. 3.3% and 9.4% in 2Q). Additional lines grew only 7.6% vs. about 9% in 2Q. Special access line growth remained robust, increasing almost 22% y/y vs. 2Q's 26% rise. Minutes of use grew 12%, vs. 2Q's 12.5% increase. Data revenues rose 42% y/y to \$430M (or 6.6% of total revenues) and a 22.1% sequential increase from 2Q's \$352M (or 5.6% of revenues). In addition, enhanced services (i.e., vertical services, CentraNet, CyberPop) revenues increased 28% y/y, which was a slight deceleration from 2Q's 30%. Total vertical service revenues increased 16.4%, in line with 2Q.

GTE has accumulated 9% LD market share (higher than our forecast of 6-7%) and has done so without crashing the LD pricing structure. Long distance revenues were approximately \$160M in 3Q, a 66% y/y increase from 3Q97's \$95M and \$140M last quarter. Long

distance customers now total over 2.5 million, with over 250,000 net additions in 3Q (in line with in 2Q's additions). Long distance customers now represent almost 13.2% of GTE's 19 million domestic switched lines, up 1.2 percentage points from 2Q's 12%. On a minutes of use basis, we estimate GTE's LD minutes — currently running at 1B/quarter— represent about 9.1% market share. We calculate that GTE's average LD rate per minute is 16¢, close to the industry average prior to GTE's entry into LD while its average customer's monthly LD bill is \$22.

Although a marked improvement over 2Q's 3.6% growth rate, GTE's domestic wireless revenue growth of 7% remained weak. GTE continues to place emphasis on higher-end wireless customers. In addition, PCS competition and new nationwide pricing plans continue to negatively impact GTE customer retention. Churn rose to 2.5%/month vs. 2.3% in 2Q and is higher than the 2%-2.2% per month industry average. As a result, subscriber growth was only 9.1%, down from 11.6% last quarter. GTE added only 58,000 subs in the quarter, down from the 86,000 added in 2Q and 3Q97's 140,000 net adds. Average revenue per customer was \$49, down 7.5% y/y but steady for the last 3 quarters reflecting its successful focus on higher revenue per month customers. Domestic wireless OCF margins increased to 39.6% vs. 3Q97's 35.7%, and 2Q's 39.3%.

GTE's operating expenses rose 8.5% y/y, better than 2Q's 13% rise and our forecast of 12%. The lighter than expected expense growth was driven by less than expected growth in cost of service expenses and depreciation and amortization. Normalizing for an accounting change which decreased depreciation expenses by approximately \$50M, we estimate normalized expense growth would have been 9.5%. Reported operating income growth was a solid 11%. Normalized for the accounting change, operating income rose 7.6%, an improvement over 2Q's 1.8% rise but less than our 11.8% forecast. In total, below-the-line items were slightly better than our forecast. The effective tax rate was 38.1%, vs. our estimate of 38.5%.

Investment Conclusion: By our estimates, GTE's earnings from core operations (excluding data, CLEC, PCS, LD start-up expenses) continue to grow near 15% y/y. We expect EPS growth including start-up dilution to accelerate to about 10% in 4Q on its way to almost 15% in '99 as the new initiatives become less dilutive in '99 and profitable during 2H00. With GTE shares trading at a 7% discount to the merger exchange ratio set with Bell Atlantic, we see 35% upside over the next 12 months given the 1.22 exchange rate applied to our Bell Atlantic (BEL, \$49 9/16 B-2-2-7) target price of \$62 which, in turn, is based on a targeted relative P/E of 90%. We continue to rate GTE shares Accumulate.