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April 26, 1999

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

EX PARTE

Ms. Magalie Roman Salas
Office of the Secretary
Federal Communications Commission
The Portals, 445 Twelfth St., N.W.
Washington, D.C. 20554

Re: SBC Communications Inc. and Ameritech Corporation
CC Dkt. 98-141

Dear Ms. Salas:

I enclose Comments of the Attorneys General of Indiana, Michigan, Missouri and Wisconsin on the proposed merger of SBC and Ameritech. These Comments provide the Commission with the views the Attorneys General developed as a result of their joint investigation of the competitive impact of the merger. I also enclose a report by Drs. Gregory Rosston and Matthew Mercurio that sets forth an economic analysis of the proposed merger and supports the Comments of the Attorneys General.

The Comments conclude that the proposed merger raises troubling competitive issues. The proposed consolidation has ended Ameritech's plans to compete head-to-head with SBC in St. Louis and elsewhere and also eliminates SBC as a potential competitor in Ameritech's territory. In addition, the merger will bolster the ability of SBC and Ameritech to resist the dissipation of their market power by diminishing the effectiveness of benchmark regulation.

The Comments explain the key role the Commission in assessing the significance of the Regional Bell Operating Companies in today's telecommunications markets. The Attorneys General recommend that the Commission attach as a condition to any approval of the merger that SBC and Ameritech be prohibited from consummating their merger until they have won section 271 approval for a majority of their combined states, including states in both their territories. This type of ex ante condition is the best available alternative for mitigating the competitive concerns the merger raises while still allowing consumers to benefit from whatever efficiencies the consolidation makes possible. The condition will not impose additional burdens on the merging parties, since they have acknowledged that qualifying for section 271 approval in their

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states is a prerequisite for the success of their proposed National Local Strategy for out-of-region competition.

We are filing the original and one copy of this letter, in accordance with the Commission's rules. Thank you.

Sincerely,

Edwin J. Hughes

Edwin J. Hughes
Assistant Attorney General

Enclosures

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

RECEIVED
APR 26 1999
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the matter of		
Applications For Consent to The Transfer of Control of Licenses and Section 214 Authorizations from	)	
AMERITECH CORPORATION, Transferor	)	CC Docket No. 98-141
To	)	
SBC COMMUNICATIONS INC., Transferee	)	

COMMENTS OF THE ATTORNEYS GENERAL OF INDIANA, MICHIGAN, MISSOURI AND WISCONSIN

I. INTRODUCTION AND SUMMARY OF POSITION

These comments are submitted by the Attorneys General of the States of Indiana, Michigan, Missouri and Wisconsin (the Attorneys General). These comments reflect the results of our 11-month joint investigation of the competitive impact of the proposed merger between SBC Communications Inc. and Ameritech Corporation.

In summary, we find that the proposed merger raises troubling competitive issues. If they were not planning to merge, Ameritech would most likely be competing in St. Louis for SBC customers today, and SBC might well be implementing plans to take on Ameritech for the local exchange business in Chicago. It may well be that each company would be a uniquely advantaged competitor in the other's territory. In addition, the merger will bolster the ability of SBC and Ameritech to resist the dissipation of their market power by diminishing the effectiveness of benchmark regulation.

We recommend that the Commission attach as a condition to any approval of the merger that SBC and Ameritech be prohibited from consummating their merger until they have won section 271 approval for a majority of their combined states, including states in both of their territories. We believe that this type of ex ante condition is the best available alternative for mitigating the competitive concerns the merger raises while still allowing consumers to benefit from whatever efficiencies the consolidation makes possible. The condition will not impose additional burdens on the merging parties, since they have acknowledged that qualifying for section 271 approval in their states is a prerequisite for the success of their proposed National Local Strategy for out-of-region competition.

A. Background

Along with the federal antitrust enforcement agencies – the Antitrust Division of the Justice Department (DOJ) and the Federal Trade Commission – state Attorneys General also have the authority and responsibility to investigate whether proposed mergers are likely to have a substantial anticompetitive effect in their states. Consistent with this responsibility, the offices of several Attorneys General for states in the SBC and Ameritech regions commenced a joint investigation of the proposed SBC-Ameritech merger. The States worked together on this investigation and coordinated efforts to the extent possible with those responsible for the DOJ investigation.

SBC and Ameritech provided a waiver to the investigating states of the confidentiality that attached to the documents that they submitted to the Department of

Justice pursuant to the Hart-Scott-Rodino Antitrust Improvements Act. We have had the opportunity to review these documents, pursuant to the terms of a confidentiality agreement, and we refer to material from the documents in these comments. We also base these comments on other information we gathered through the course of our investigation.

The Attorneys General also retained the services of Dr. Gregory Rosston of Stanford University and Dr. Matthew Mercurio of Economists Incorporated to help us examine the likely competitive impact of the proposed merger. We submit with these comments the report Dr. Rosston and Dr. Mercurio have prepared that sets forth their analysis.

While we cooperated with DOJ in fact-finding and document review, and we discussed our views of the merger with attorneys working on the review at DOJ, we have applied our own analysis to the facts we found. We do not purport to speak for DOJ in any way in these comments.

B. The Commission Is Well Positioned to Address the Complex and Novel Competitive Issues Raised by This Merger.

DOJ has concluded that its concerns about the competitive impact of the merger are adequately addressed by the parties' willingness to divest their overlapping cellular properties.[1] Similarly, while the matter is still under review, the States have not at this time commenced litigation seeking an injunction prohibiting the merger under § 7 of the Clayton Act.

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[1] *See* Department of Justice Press Release, Justice Department Requires SBC to Divest Cellular Properties in Deal with Ameritech and Comcast (March 23, 1999), available at <http://www.usdoj.gov/atr/public/press_releases/1999/2322.html>.

It is inappropriate to infer from the States' inaction to date that we have concluded the merger does not raise significant competitive issues. To the contrary, there are serious competitive problems raised by this merger, including concerns related to the telecommunications industry's history of regulation, that traditional approaches to merger analysis are not designed to detect or assess.

For example, the traditional method for assessing the competitive impact of a proposed merger is described in the 1992 Merger Guidelines. The approach is designed to evaluate whether a merger will lead to a competitively significant increase in market concentration. It is not intended to assess the significance of one of the dangers this merger presents: that it will dangerously strengthen the merged firm's ability to resist the dissipation of existing market power.

Similarly, the risk that a merger will eliminate significant potential entrants into a concentrated market is traditionally addressed through application of the potential competition doctrine, which is described in the 1984 Merger Guidelines. SBC and Ameritech are both key potential entrants into each other's home territories. However, it is sometimes a challenge to appreciate the significance of their status when the proponents of the merger list all the other types of telecommunications firms that might also seek to compete in local exchange markets. The elimination of an RBOC potential entrant may well cause competitive harm that is not mitigated by the presence of other types of potential entrants into another RBOC's territory.

As the expert agency responsible for the implementation of the procompetitive directives of the Telecommunications Act of 1996, this Commission is uniquely positioned to assess the concerns raised by this merger that derive from the competitive significance of RBOCs in today's telecommunications markets. This Commission is the appropriate fact-finder and decision-maker with respect to issues that so directly invoke its expertise.

In addition, the Commission can deal more flexibly than a court with a merger that raises competitive problems but is also likely to generate public benefits. If an antitrust enforcement agency proves that a proposed merger is likely to reduce competition substantially, the appropriate remedy is an injunction against consummation of the merger. The courts lack authority to craft a result that addresses the probable anticompetitive consequences of the merger while permitting the transaction to proceed. In contrast, the Commission may impose conditions on its approval of a merger that are designed to rectify the problems the merger presents without impeding the benefits that it promises.

The States believe that this Commission rather than a district court judge is better able to address the complex and novel competitive issues raised by this merger. This recognition of the agency's expertise should in no way be seen as a tacit conclusion that the merger does not raise any significant competitive concerns, or – worse yet – be offered as justification for the Commission to avoid altogether an assessment of the merger's difficult competitive issues.

II. FACTS REGARDING ENTRY PLANS

Both Ameritech and SBC undertook studies of the options available for them to enter new local exchange markets following passage of the Telecommunications Act of 1996. Ameritech's studies were grouped under its Project Green. This project, which began in 1996, encompassed explorations of a number of entry strategies, including entry into local exchange markets in areas adjacent to Ameritech's territory, and plans to offer local exchange and other services out of region to Ameritech's largest in-region customers with national operations.

Two initiatives of significance resulted from Ameritech's Project Green study of competitive opportunities. The first, Project Gateway, consisted of a plan to utilize the company's cellular operations in St. Louis as a base for offering a bundle of services, including local exchange, long distance and cellular, to St. Louis customers in direct competition with SBC, the incumbent local exchange provider in the city. The second initiative, the Managed Local Access plan, contemplated strategies for providing local exchange and other services to the out-of-region operations of Ameritech's largest business customers. These two initiatives are discussed in the following sections of these comments.

A. Ameritech's Project Gateway Plan for Competing with SBC in St. Louis

Project Gateway represented the first significant competitive foray by an RBOC into the territory of another RBOC. The project encompassed a plan for Ameritech's cellular business unit in St. Louis to offer a bundle of local exchange, long distance and cellular services. This bundled product was initially geared toward Ameritech's existing cellular customers in St. Louis, with plans to expand the target market to other residential and small business customers in the area.

Project Gateway received the necessary approval by the Ameritech Management Committee in May, 1997. The company then undertook the tasks necessary to have its bundled product available in the St. Louis market by November of that year. As the fall approached, problems with the interconnection agreement with SBC and regulatory approval issues delayed progress, and the launch date for the project slipped.

Ameritech's interconnection agreement with SBC was approved on November 4, 1997. On November 6, Ameritech filed its local exchange service tariff and issued a press release announcing its plans to offer local and long distance phone services to residential customers in the St. Louis metropolitan area in early 1998.

In January, 1998, Ameritech began offering local exchange service in St. Louis on a trial basis to a group of friendly users. A general launch date for the service, with full media coverage, was set for April 8. By early April, the program was operationally ready for launch as soon as the appropriate cellular executives gave their approval. (All tasks had been completed except a redesign of the bill format.)

On April 6, 1998, the Executive Committee within Ameritech Cellular surprised the Gateway team with the announcement that the launch would be delayed two weeks, until April 22, ostensibly to give the staff more time to run tests and check systems. (In fact, the merger negotiations were underway by this time.) The launch date continued to slip, past April 22 and into May. On May 10, 1998, Ameritech and SBC announced their plans to merge. On May 21, Project Gateway was put "on hold." There seems little doubt that the pendency of the proposed merger prompted Ameritech officials to call off the Project Gateway initiative for competing head-to-head with SBC in St. Louis.

SBC and Ameritech attempt to minimize the competitive significance of Project Gateway in their filings. For example, the Applicants' Reply Comments to the Commission state, "Ameritech Cellular's 'Project Gateway' in St. Louis was intended to be very limited and entirely defensive." (Joint Opposition of SBC Communications Inc.

and Ameritech Corporation to Petitions to Deny and Reply to Comments (Applicants' Reply Comments) at 46) However, an Ameritech memo written two months before the merger was announced discusses plans to market Ameritech's services more broadly than Applicants concede:

> In conjunction with the Cellular customer promotion mentioned above, SW Bell customers (who are not current cellular customers) will be targeted for acquisition efforts via mail. Cellular will be offering them the same package as previously mentioned: local, long distance and cellular from Ameritech. A cellular customer profile has been developed and the SW Bell mailing will target those customers who "look like" a cellular customer. Weekly mailings will go to residential SW Bell customers with a target to acquire 30,000 Full Service customers by 1998.[2]

Ameritech expected to win somewhere between two and three percent of the St. Louis local exchange market in 1998, with its market share increasing to about 15% by 2003. Project Gateway was initially targeted at protecting Ameritech's base of cellular customers from competition from the expected bundled offerings of other cellular providers, but, as Ameritech documents attest, the project also contemplated attracting switchers and prospects. The initial targets were residential customers, and Ameritech intended to expand its marketing to small businesses by late 1998 or early 1999.

Applicants also assert in their reply comments that Ameritech was not distinctively advantaged as a potential entrant into St. Louis by its strong brand image in that market: "[I]n contrast to Bell Atlantic's longstanding presence and name recognition in the New York area, Ameritech has only used its name in St. Louis for four years and only in connection with its wireless service." (Applicants' Reply Comments at 51) However, this

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[2] March 10, 1998 Memorandum from Patti Burkamp, Melanie Murphy and M.J. Zayac of Ameritech to St. Louis Gateway Center, et al., regarding Gateway and Discount Dialing Coordination Effort, at 3 (AIT0405278).

claim is belied by Ameritech's own documents. An Ameritech memo explains, "Ameritech already has a strong market presence in St. Louis. We provide cellular, paging and security monitoring services to thousands of customers. And we provide local phone service to additional hundreds of thousands in the Illinois portion of the metro area. . . . Ameritech is already a strong well-recognized brand in the market."[3] Similarly, Ameritech's November, 1997 press release touting the service, quoted an Ameritech executive, "The Ameritech brand is already strong [in the St. Louis market], as evidenced by our superior customer growth in cellular and paging."[4]

Ameritech studied the relative feasibility of entering St. Louis through a resale strategy, as well as through a facilities-based strategy utilizing unbundled network elements. The analysis showed that, at least initially, resale was more financially promising because the higher gross margins available for the UNE-based strategy were more than offset by the higher up-front capital costs required to purchase the necessary switching equipment. Resale was also a less risky strategy, since the company would have much less sunk investment if the initiative proved to be a failure.

In addition, a UNE-based strategy would require more cooperation from SBC than resale. Ameritech should have been well aware of the strategies available to ILECs to delay competitive entry. It would make sense for the company to conclude that resale offered the best opportunity to Ameritech to seize whatever first-mover advantages might

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[3] "Background Qs and As - Project Gateway (Draft: 9/29/97)" at 1 (AIT0609588).

[4] Ameritech News Release, "Ameritech to Expand in St. Louis, Will Give Customers Competitive Choice in Local, Long Distance Phone Services," November 6, 1997, at 2 (AIT0023295).

be available to the company that was able to beat competitors to the market with a bundled product offering geared to cellular customers.

Ameritech did not dismiss a UNE-based strategy completely. The company planned to begin to offer local exchange service through resale, but always with the potential to shift gradually to a facilities-based approach in the future. The company was well aware that a UNE-based product offered significantly better margins than resale. Indeed, it is hard to imagine that the company would not keep close tabs on the potential payoffs from utilizing UNEs. Ameritech would certainly utilize UNEs into its St. Louis operations to the extent that it made economic sense to do so. As Ameritech's project Gateway market share increased, the case for incorporating UNEs in its St. Louis local exchange operation would grow more and more compelling.

B. Ameritech's Managed Local Access Initiative

The second out-of-region initiative in SBC's territory that Ameritech pursued prior to the merger was its Managed Local Access project. This project was based on a "follow the customer" strategy by which Ameritech sought to provide local exchange and other services to out-of-region locations of its largest business customers.

In conjunction with this project, Ameritech sought certification as a competitive local exchange carrier (CLEC) in a number of states where its largest customers had operations. Ameritech was certified as a CLEC in California, Texas, and New York, and was planning to win CLEC certification in five additional states in 1998 (Florida, North Carolina, Colorado, Georgia and Arizona) and in another eight or nine states in 1999. In those states in which it was certified as a CLEC, Ameritech initially planned to provide local exchange service on a resale basis, but it never lost sight of the possible feasibility of moving towards facilities-based offerings as its business grew.

The Managed Local Access initiative clearly contemplated establishing competitive beachheads in SBC's territory. Indeed, at the time the merger was announced, Ameritech had underway a promotion called "Try Us in Texas," where it was offering its top 25 corporate customers with operations in Texas 10% off their current Southwestern Bell local exchange tariff rate in an effort to win the business of managing the day-to-day operations of their local access services throughout the state.

The Managed Local Access project was launched during the fourth quarter of 1997 and terminated in late June, 1998. Applicants claim that this initiative was ended because of disappointing results – the only customer Ameritech obtained was United Airlines. While the program was falling short of projections, it appears that United was considered a test customer all along and that the program had not yet progressed to the point where there was a sufficient basis for termination in the absence of the merger.

C. SBC's Potential Entry into Chicago and Elsewhere in the Ameritech Region

Like Ameritech, SBC studied the feasibility of out-of-region competitive initiatives following passage of the Telecommunications Act of 1996. The company is on record in describing its plans to invade Ameritech's territory by offering local exchange service in Chicago based on a model similar to Ameritech's Project Gateway. For example, in October 1996, in the California SBC/Pacific Telesis merger proceeding, SBC's James Kahan, testified:

> [W]e have concluded that it would make sense to enter the local exchange market in Chicago but not in Los Angeles. In Chicago, we have a extensive

> wireless network consisting of 10 switches and over 600 cell sites. That network also includes extensive backbone network of microwave, leased facilities, and connections to a SONET ring. This network is supported by a sophisticated billing system, a responsive care unit, as well as sales and distribution marketing, accounting finance, installation and maintenance and other personnel who reside in and understand the Chicago market. In addition, we have a well recognized brand name since we operate under the Cellular One name in Chicago. We also have a large existing customer base to which we send bills every month and to whom we could market services.[5]

SBC responds that its plans to enter in Chicago and elsewhere out-of-region were put on hold when its experiment of offering competitive local exchange service in Rochester, New York was a failure. SBC's documents indicate that in fact the Rochester program did not meet the company's goals.

It is certainly possible to question whether SBC would terminate all of its plans for out-of-region competition based on its somewhat limited experience with competition in Rochester. The proposed merger does make it clear that SBC would prefer to obtain a presence in the Chicago market by acquiring Ameritech rather than by earning its market share through head-to-head competition with the company.[6] However, this preference for

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[5], *In the Matter of the Joint Application of Pacific Telesis Group and SBC Communications Inc. for SBC to Control Pacific Bell*, Rebuttal Testimony of James S. Kahan (SBC), California Public Utilities Commission, Docket 96-05-038, October 15, 1996, at 2.

[6] SBC's aggressive strategy of growth through acquisition of large ILECs represents a sharp departure from what the company had told the Commission in 1995. In seeking a waiver of the Commission's rules requiring separate subsidiaries for cellular and wireline services, Southwestern Bell Mobile Systems stated that it proposed to offer integrated cellular and local exchange service in Rochester and other markets. The company pointedly represented that its entry "will be on a *competitive* basis, either through direct entry itself or through acquisition of another competitor, but *not* as a replacement for the existing LEC." *Motion of Southwestern Bell Mobile Systems, Inc. for a Declaratory Ruling That Section 22.903 and Other Sections of the Rules of the Commission Permit the Cellular Affiliate of a Bell Operating Company to Provide Competitive Landline Local Exchange Service Outside the Region in Which the Bell Operating Company Is the Local Exchange Carrier,* Motion for Declaratory Ruling,

merger does not necessarily imply a rejection of other types of out-of-region initiatives as second-best approaches.

For purposes of competitive analysis of the proposed merger, the issue is what course SBC is likely to follow if its strategy for expansion through merger is blocked, a point addressed in section II of the Rosston-Mercurio report. We do not assume that SBC would simply retreat into a defensive shell. It does not appear that SBC had out-of-region competitive initiatives comparable to Ameritech's Project Gateway and the Managed Local Access plan actively underway at the time the merger was announced. However, given the previous sworn statements by company officials about its plans to invade Chicago and the competitive imperative toward out-of-region competition that SBC witnesses in this proceeding have identified and described, the conclusion appears fully warranted that if the proposed merger were blocked, SBC would compete in Chicago and elsewhere in Ameritech's territory one way or another before much time had passed.

III. ANALYSIS

A. Contrary to the Arguments of SBC and Ameritech, The Proposed Merger Raises Competitive Concerns Because It Eliminates Potential Competition and Fortifies the Companies' Market Power.

1. SBC and Ameritech have not demonstrated that the proposed merger is competitively benign.

SBC and Ameritech argue that their proposed merger will not result in any significant diminution of competition. According to the companies, their only direct

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CWD Docket No. 95-5, dated June 21, 1995, at ii (emphasis in original).

competition is in their overlapping cellular territories – a problem remedied by the proposed consent decree with DOJ – as well as some *de minimis* competition for local exchange service to large business customers and for long distance service outside their home territories. (Merger of SBC Communications Inc. and Ameritech Corporation, Description of Transaction, Public Interest Showing and Related Demonstrations, at 59)

The parties also assert that the merger will not eliminate any substantial potential competition because neither SBC nor Ameritech is a "most significant market participant" in any market in which the other is the incumbent LEC. (*Id.* at 63) Two of the parties' stable of economic experts, Richard Schmalensee and William Taylor, invoke the 1984 Merger Guidelines for the assertion that a merger is unlikely to be challenged on potential competition grounds if three or more potential entrants have the same or comparable advantages in entering the market. (Reply Comments of Richard Schmalensee and William Taylor, (November 11, 1998), ¶2, citing § 4.133 of the 1984 *Merger Guidelines*) The Applicants claim that SBC and Ameritech possess no special advantage in entering each other's markets not shared by many other competitors, including at least AT&T, MCI WorldCom and Sprint. Accordingly, they contend that the potential competition doctrine has no applicability here.

SBC and Ameritech are too hasty in dismissing out of hand the potential competition concerns the merger raises. The theory of potential competition focuses on a merger's future effects on competition in a market where the merged entities do not presently compete. The potential competition doctrine has been developed under Section 7 of the Clayton Act, which prohibits any merger where the effect of the acquisition may be substantially to lessen competition or to tend to create a monopoly. *15 U.S.C. § 18, 21*

(1998). See, e.g, Yamaha Motor Co. v. F.T.C., 657 F.2d 971 (8th Cir. 1981), *cert. denied*, 456 U.S. 915 (1982); *Mercantile Tx. Corp. v. Board of Governors,* 638 F.2d 1255 (5th Cir. 1981); *BOC International Ltd. v. F.T.C.*, 557 F.2d 24 (2d Cir. 1977); *United States v. Consolidated Foods Corp.*, 455 F. Supp. 108 (E.D. Penn. 1978).

The significance of the potential competition doctrine was explained by Justice Marshall in *U.S. v. Falstaff Brewing Corp.*, 410 U.S. 526, 561 (1973) (J. Marshall, concurring):

> [W]here a powerful firm is engaging in a related line of commerce at the fringe of the relevant market, where it has a strong incentive to enter the market *de novo*, and where it has the financial capabilities to do so, we have not hesitated to ascribe to it the role of an actual potential entrant. In such cases, we have held that § 7 prohibits an entry by acquisition since such an entry eliminates the possibility of future actual competition which would occur if there were an entry *de novo*.

To show that a merger would have an adverse effect on competition through elimination of a potential competitor, the following elements must be established:

1. The market must be concentrated;
2. Entry must be likely to occur;
3. The entrant must be one of a few firms uniquely well situated to enter; and
4. The entry must deconcentrate the market or result in other procompetitive effects.

See U.S. v. Marine Bancorp. 418 U.S. 602, 633 (1974)

As Drs. Rosston and Mercurio explain in Section II of their report, the evidence establishes that, in the absence of the merger, Ameritech clearly would have entered the local exchange market in SBC territory, and SBC could have been a significant competitor in Chicago. Both Ameritech and SBC are uniquely positioned potential entrants into the other's territory because they have extensive experience as local exchange providers, they serve an adjacent territory as the incumbent LEC, and they have a market presence and customer relationships in the other's territory through their cellular operations. Drs. Rosston and Mercurio explain that while today it is impossible to know what type of entrants will ultimately succeed in creating competitive local exchange markets, it is certainly possible that Ameritech's entry into St. Louis or a competitive foray by SBC into Chicago could spark the development of effective local competition in those markets. As the Rosston-Mercurio report concludes, the proposed merger raises significant concerns on potential competition grounds, because it eliminates Ameritech as a potential entrant into St. Louis and SBC as a potential entrant into Chicago, and might thereby significantly delay the benefits of competition to consumers in those cities.

What is more, the arguments of SBC and Ameritech prove too much. If RBOC mergers are to be judged by the traditional Merger Guidelines or potential competition approaches, then there seems no principled reason to oppose *any* RBOC merger, and the local exchange component of the Bell system could be completely knit back together after the nearly twenty-year experiment set in motion by the MFJ.

No RBOC currently competes significantly in any other RBOC's local exchange markets, and so no RBOC merger would eliminate actual competition. If the Applicants' premise is accepted that an RBOC is not significantly different from any IXC or CLEC as a potential competitor in another RBOC's territory, then the actual potential competition doctrine would likewise supply no basis for challenging any RBOC merger.

A merger combining all the remaining RBOCs into one firm would clearly raise severe competitive concerns. That such a mega-merger would not run afoul of merger proponents' interpretations of the standards incorporated in traditional Merger Guidelines and potential competition analyses reveals more about the limitations of those analytical approaches than the genuine competitive impact of such a merger. The following sections of these comments explore possible anticompetitive consequences of RBOC mergers that the traditional methods of analysis overlook.

2. The merger will strengthen the merged firm's ability to resist the dissipation of existing market power through benchmark regulation.

Traditional antitrust merger analysis examines whether a merger will equip a firm with the ability to exercise market power. The focus of the analytical approach described in the Merger Guidelines is on whether the merger will result in a sufficient *increase* in concentration that the merged firm will be able profitably to maintain a price increase above the pre-merger level.[7] The approach generally does not consider the effect of mergers on solidifying the firms' defensive strategies, such as enabling the firms to better resist the competitive forays of other firms in the market. In typical markets this makes sense, because it is the unusual case where the merging parties already possess market power in their own markets and hence are motivated by a defensive desire to maintain that power.

This helps explain why traditional merger analysis may not be the most appropriate way of analyzing the competitive significance of the proposed merger of SBC and

[7] As the Merger Guidelines explain: "A merger is unlikely to create or enhance market power or to facilitate its exercise unless it significantly *increases* concentration *and* results in a concentrated market, properly defined and measured. Mergers that either do not significantly increase concentration or do not result in a concentrated market ordinarily require no further analysis." (§ 1.0 Overview, emphasis added)

Ameritech, and why the Commission has a vital role to play in assessing the competitive impact of the merger separate from the reviews of the antitrust enforcement agencies.

Like all RBOCs, Ameritech and SBC have localized market power, as Drs. Rosston and Mercurio explain in section II of their report. While competitors have made some limited progress in entering the local exchange business in their markets, SBC and Ameritech continue to control the vast majority of local access business.[8] In addition, most of their fledgling competitors are dependent upon some level of cooperation from Ameritech and SBC in the operations of their business. Some competitors are facilities based, and the AT&T-TCI merger holds promise of facilitating an entry strategy free of dependence on the RBOCs' facilities, but for now the RBOCs' entrenched position, and particularly their control over the last mile, equips them with clear market power in the local exchange markets they serve.

This merger is obviously intended to accomplish something. There must be a reason why the dwindling number of RBOCs prefer to merge with other incumbent local exchange companies – occasionally paying handsome premiums for the privilege – rather than acquiring competitive local exchange carriers, as AT&T and MCI WorldCom have done.

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[8] According to a recent report released by the President's Council of Economic Advisors, currently competitive local exchange carriers represent only between 2 and 3 percent of the local exchange market as measured by access lines, and only about 5 percent of the market as measured by revenues. The remainder of the market, between 95 and 98 percent, is controlled by incumbent local exchange carriers. *See* The State of Competition in the Telecommunications Marketplace Three Years After Enactment of the Telecommunications Act of 1996, Testimony of Assistant Attorney General Joel I. Klein before the Subcommittee on Antitrust, Business Rights, and Competition, Senate Judiciary Committee, February 25, 1999, at 3.

Given the existence of RBOC market power, it seems as if RBOC mergers might be explained as intended to strengthen the merged firms' abilities to resist the dissipation of that market power. The mergers have this effect because, from what amounts to the buyers' point of view, RBOCs can be seen as competing with each other with respect to cooperation with CLECs and regulators in market-opening initiatives. CLECs and regulators – this Commission and State PUCs – search among the RBOCs for differences in their receptiveness to competitive initiatives, just as buyers shop among sellers for lower prices or better terms. As Drs. Rosston and Mercurio explain in section III of their report, if one RBOC makes a concession, regulators and CLECs will press the others to match it. Through this benchmarking process, regulators respond to the informational advantage of the RBOCs and work towards the most efficient regulatory structure possible.

Opponents of the merger have provided a number of examples of the use of benchmarking as a regulatory tool employed by the FCC and state commissions.[9] For example, in considering Ameritech's refusal to provide shared transport to CLECs, the FCC and state commissions have relied in part on the fact that other RBOCs had agreed to make the service available for their rejection of Ameritech's claim that it was technically infeasible to provide the service. US West's agreement to provide cageless collocation in Washington was cited by the Commission as support for its finding that all incumbent

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[9] *See* Declaration of Joseph Farrell and Bridger M. Mitchell, "Benchmarking and the Effects of ILEC Mergers," October 14, 1998, Attachment C to Petition to Deny of Sprint Communications Company L.P; "Response to Some Criticisms of Benchmarking Analysis," Joseph Farrell and Bridger M. Mitchell, April 9, 1999, attached to an April 12, 1999 ex parte submission by Michael Jones on behalf of Sprint Communications Company, L.P.; "Memorandum Re: SBC-Ameritech and Bell Atlantic-GTE Mergers," Robert H. Bork, April 7, 1999, attached to a April 7, 1999 ex parte submission by Peter Keisler on behalf of AT&T Corp.

LECs should be required to make cageless collocation available. Ameritech's recommendation of the Location Routing Number (LRN) method for implementing local number portability requirements, in the face of the support of the other RBOCs and GTE for the Query on Release (QOR) method, provided important support for the Commission's conclusion that LRN was practical.

As opponents of the merger have observed, an RBOC merger like that proposed between SBC and Ameritech significantly diminishes the utility of this regulatory tool. A merger enables the surviving RBOC to reduce the possibility that the independent decisions of other RBOCs would undercut the strategy it has adopted to respond to its market-opening obligations. RBOC mergers tend to facilitate the presentation of a united RBOC front and coherent strategy to the CLECs and regulators that are trying to pry their markets open.

Under traditional potential competition analysis, an RBOC as a potential entrant into another RBOC's territory might be considered one of a pool of potential competitors that may include CLECs, IXCs and others. However, from a benchmarking perspective, there is a meaningful way in which RBOCs compete only with other RBOCs in the extent and manner in which they respond to their local exchange market-opening obligations. From this perspective, the elimination of an RBOC through merger does have a significant adverse effect on the extent to which this sort of "competition" can generate useful information for regulatory purposes, and it does lead to a market more conducive to tacit collusion.

This merger will result in a diminished ability for regulators to compel the opening of all RBOCs' markets to competition. It will result in the loss of an independent decision-maker. On policy issues with competitive ramifications – for example, the extent to which and how the RBOC will cooperate with competitors seeking to offer xDSL service – chances are that Ameritech and SBC will have different approaches on many issues. As a result of the merger, and SBC's subsequent control of the merged firm, Ameritech's different approaches will be lost.

This loss of independent decisions by Ameritech will result in a loss for competition, even assuming that Ameritech's individual decisions are no more likely to be hospitable to competition than the individual decisions of SBC. Each individual approach that will be lost would have been either more or less competitive than the approach of SBC. If the independent Ameritech approach would have been more pro-competitive than SBC, then consumers in the Ameritech states in particular and regulators in general will be worse off as a result of the loss of those decisions due to the merger. If the independent Ameritech approach would have been more anti-competitive than SBC, then the effect of the merger is more beneficial for competitors and customers in Ameritech's territory and the loss of this additional data point will not impede the regulatory process.

But the benefits and detriments are asymmetrical. There is no way to compensate for the loss of any future pro-competitive Ameritech positions that will not be adopted as a result of the merger, because regulators will never be aware of the losses. This loss is not balanced out by the post-merger benefits resulting from those situations where SBC's position will be more pro-competitive. This is because, in the absence of the merger, regulators would be aware of SBC's position and could be in a position to insist that it be adopted by Ameritech.

Regulators could mitigate the adverse effects of Ameritech adopting the more anticompetitive position in the absence of the merger far more effectively than they could mitigate the post-merger adverse effects resulting from those situations where, but for the merger, Ameritech would have adopted a more procompetitive approach. Regulators are always better off with two data points rather than one.

It may be that the status of SBC and Ameritech as potential competitors in each other's territory, standing alone, does not significantly restrain either from the exercise of market power. However, the status of each as a regulated RBOC may well restrain the other in its ability to resist the process of opening its local markets to competition. This explains the logic of the Commission's warning in its *Bell Atlantic/Nynex* order that "further reductions in the number of Bell Companies or comparable incumbent LECs would present serious public interest concerns."[10]

B. The Katz/Salop "Big Footprint" theory is analytically sound but appears insufficiently quantifiable in this instance to justify blocking the merger.

One of the arguments raised against the SBC-Ameritech merger is based on a theory developed by Michael Katz and Steven Salop.[11] The theory proceeds from the premise, first, that ILECs like SBC and Ameritech possess market power with respect to the provision of access services in their territories. Next, the theory assumes that ILECs

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[10] *In re Applications of NYNEX Corp. and Bell Atlantic Corp.*, Memorandum Opinion and Order, 12 FCC Rcd. 19985, ¶ 56 (1997).

[11] See Declaration of Dr. Michael L. Katz and Dr. Steven C. Salop, "Using a Big Footprint to Step on Competition: Exclusionary Behavior and the SBC-Ameritech Merger," October 14, 1998, Attachment B to Petition to Deny of Sprint Communications Company L.P.

have an incentive to degrade the quality of the access services they provide to their rivals when that degradation shifts customer demand to the ILEC's competing services.

According to Katz and Salop, a large-scale ILEC merger increases the merged firm's incentive to degrade access services to the extent that the merger allows the firm to internalize anticompetitive spillover effects that previously had benefited the surviving firm's merger partner. As Drs. Rosston and Mercurio point out in section IV of their report, this can happen in two ways. First, to the extent that the anticompetitive activities harm a national CLEC, the injured firm may be forced to scale back on its national entry plans. This benefits ILECs around the country, and the merged firm receives the benefits attributable to its incumbent status in the territory formerly served by its merger partner.

Second, actions by the merged firm that degrade the quality of access service provided to a CLEC competitor impair that competitor's ability to win customers who originate calls from all around the country, including from the territory previously served by the merger partner. This should lead to the merged firm winning more customers who are located in the expanded territory that the merged firm now serves.

The Katz-Salop theory reasons that regulation will not be entirely effective in prohibiting the increased anticompetitive actions that the merger makes attractive, and so the merger will lead to tangible harm to competitors and consumers. Because it is premised on the increase in the size of the territory served by the merged firm, the Katz-Salop analysis is sometimes referred to as the Big Footprint theory.

Like most of the theories underlying antitrust analysis, the Big Footprint approach is based on the assumption that firms carefully calibrate their level of anticompetitive behavior based on a close assessment of its likely costs and benefits. The logic proceeds as follows. Pre-merger, SBC and Ameritech already have incentives to injure their rivals. They also have means available to work such an injury that they are not yet exploiting, even though it is not effectively checked by regulation. The companies are not taking advantage of this anticompetitive opportunity because the expected benefits of implementing the strategy are just outweighed by its expected costs. (The possible costs of the strategy would include the expense of implementing it and the sanctions that are likely to be imposed if the actions are found to be unlawful, discounted by the likelihood of detection.) After the merger is consummated, the merged company's incentive to take the anticompetitive strategy is increased, because the merger permits the company to internalize some of the spillover benefits of the strategy that would previously flow to the merger partner. This increase in incentives is enough to tip the balance, and now the company will adopt the strategy, to the detriment of the company's rivals and the competitive process.

The fact that the post-merger SBC might not explicitly undertake the analysis that this theory predicts is insufficient reason to reject it. The theory is a general one applicable to all large ILEC mergers, not specifically limited to SBC and Ameritech. Like the theories that underlie most antitrust analysis, it recognizes that it is useful to assume that firms will rationally act in ways intended to maximize their profits. Acceptance of this assumption is a practical necessity for the development of any theories predicting how mergers might lead to future anticompetitive effects.

We share the assumption implicit in the Katz-Salop analysis that this merge may raise competitive concerns that are not fully captured through traditional competitive analysis. We also believe that the Big Footprint analysis is sound as a matter of theory and yields valuable insights. The difficulty with the theory from an enforcement perspective is that it is applicable to a greater or lesser extent to any ILEC merger. At this relatively early point in the theory's development, we are unaware of any way to quantify its predicted anticompetitive effect and determine for which mergers, if any, that effect is too significant to permit the merger to proceed.

C. The Serious Competitive Concerns Raised by the Merger Are Unlikely to Be Outweighed by Competitive Benefits Resulting from the National Local Strategy.

1. Applicants' National Local Strategy

According to Applicants, the merger should be understood as inextricably bound to SBC's proposed National Local Strategy (NLS). This strategy contemplates that the merged firm will provide facilities-based competition for the local exchange needs of business and residential customers in 30 top markets outside of the combined SBC-Ameritech territory. The companies expect to begin to implement this strategy almost immediately after consummation of the merger.

Applicants state that they will provide service to the 30 out-of-region markets utilizing what they term a "smart build" strategy. This contemplates the installation of switches and the construction of fiber networks in the targeted out-of-region cities. SBC expects to purchase intercity transport to link its out-of-region networks from third parties, and to lease unbundled loops from ILECs. The goal is to provide services in geographic markets that account, both in and out of region, for at least 70 to 80% of the telecommunications expenditures of the largest business customers with headquarters in the merged company's territory. (224 of the Fortune 500 companies have headquarters in the territories of SBC and Ameritech.)

The initial focus of the Local National Strategy will be on the needs of the merged firm's largest business customers. Using the business generated by these large business customers as a base, the company then expects to expand to offer local exchange service to small business and residential customers in its 30 targeted out-of-region markets. The process should take about four years. According to SBC's James Kahan, "SBC expects to capture between 5-10% of the addressable business and residential customers by the end of the plan." (July 20, 1998 Affidavit of James S. Kahan, ¶ 43) Large business customers are expected to account for the predominant share of this business, since Kahan also states that the company anticipates an overall penetration rate of about 4% of the residential and small business customers in these markets. (Kahan Aff., ¶ 63)

Applicants claim that implementation of the National Local Strategy will also lead to increased competition in the merged company's home territory. The theory is that the ILECs whose territories are invaded by SBC as a result of the NLS will feel impelled to respond by undertaking similar out-of-region initiatives in the merged firm's home territory.

Applicants tout the increased facilities-based local exchange competition engendered by its National Local Strategy as the key benefit made possible by the merger and the clearest demonstration that the merger is in the public interest.

2. The merger-specific competitive benefits of the NLS do not appear to be substantial.

An assessment of the proposed merger under the Commission's public interest standard requires an evaluation of the competitive harms that the merger may engender, balanced against the public benefits that the merger may create. The primary benefit Applicants identify is the increased local exchange competition that will result from implementation of the NLS. The Commission must consider the cost in terms of competitive benefits foregone if it were to deny the transfer applications on the basis of the competitive concerns that the proposed merger raises. As Drs. Rosston and Mercurio discuss in section V of their report, other avenues for competition available to SBC and Ameritech would significantly limit the loss to consumers that would result if the merger were blocked and the parties were unable to implement the NLS in the manner they have described.

For there to be a significant loss to competition attributable to a failure of the merger, one has to assume that the National Local Strategy will unfold in the way Applicants describe. This is no sure thing. It may well be that, for whatever reason, the company's projections prove overly optimistic. The three years since passage of the Telecommunications Act of 1996 have been littered with discarded plans of unsuccessful competitive initiatives, and there is no assurance that SBC's latest strategy will unfold in quite the way the company expects. If it does not, and if in fact it appears that the plan does not make economic sense, there is no way to compel the company to continue. Nor should the company be forced to continue under those circumstances. The unavoidable fact is that the claimed competitive benefits of the National Local Plan are inherently speculative at this point.

The plan is initially directed at the merged company's largest business customers, just as Ameritech's Managed Local Access Plan was. There appear to be good reasons for this initial focus on the largest customers, but, as the Commission has found, this is the segment of the market for which the most competitive options are already available. This segment of the market will continue to be relatively more competitive regardless of whether this plan proceeds.

Recognizing this point, Applicants argue that they intend to expand into small business and residential markets in their 30 targeted out-of-region cities, once their local networks are in place and they have first attended to the largest business customers that are the focus of the plan. SBC's Mr. Kahan has stated that "We anticipate that we will achieve an overall penetration rate of 4 percent of residential customers in all of these 30 markets." (Kahan Aff., ¶ 63)

A broad-based effort to compete for residential business in these 30 markets, utilizing a UNE strategy, would represent a genuine competitive benefit attributable to the merger. It should be noted that SBC "plans to offer service to a majority of the households in the 30 out-of-region markets within four years of closing." (Kahan Aff., ¶63) We certainly hope that the market for residential local exchange service in large urban areas is more competitive four years from now than it appears today, and so the procompetitive impact of SBC's plans might not appear as significant at that time as it does today. Nonetheless, SBC's plans to offer local exchange service on a competitive basis in 30 out-of-region markets within the next four years does count as a potential competitive benefit of the merger.

The National Local Strategy, standing alone, does not promise any direct competitive benefits to consumers in SBC's and Ameritech's home regions. Recognizing this, Applicants contend that the plan will have an indirect beneficial effect by prompting

RBOCs whose markets SBC will be invading to respond by competing for business in the merged SBC's home region.

As section V of the Rosston-Mercurio report explains, this argument is not entitled to much weight. First, if competing for business in SBC's home region appears to be an attractive opportunity for an RBOC like Bell Atlantic, then it will seek to compete for that business regardless of whether SBC implements its National Local Strategy. The other RBOCs do not need implementation of the National Local Strategy to alert them to the possibility of out-of-region competition.

Second, if the Applicants are correct about the size and scope an RBOC must possess in order to undertake something like the National Local Strategy, then it will be beyond the reach of Bell South and US West as they are presently constituted. Only Bell Atlantic could possibly undertake the sort of retaliatory strategy Applicants describe. But if the "first-mover advantages" described by the applicants' witnesses are valid, then even Bell Atlantic may be sufficiently weakened by loss of some of its largest business customers to SBC's National Local Strategy that it will not be in a position to mount an effective retaliatory response, even if that seemed like an efficient strategy. Bell Atlantic's attention would likely first be concentrated on defending its home turf. In sum, we do not attach much credence to Applicants' argument that the National Local Strategy will have procompetitive spillover effects in the merged company's expansive home region.

While the National Local Strategy might well have some benefits in enhancing competition in residential local exchange markets in the 30 out-of-region cities over the next few years, those benefits must be weighed against the competition that will be foregone as a result of the merger. Most obviously, the merger proposal has led to the elimination of competition for residential local exchange business that otherwise would likely be taking place in St. Louis today. In addition, if the merger is blocked, both Ameritech and SBC would be likely to implement other out-of-region competitive strategies in the years ahead (In reaching this conclusion, we find not entirely credible SBC's Mr. Kahan's affidavit statement that "In the absence of the merger, SBC . . . does not contemplate out-of-region entry into local exchange markets." (Kahan Aff., ¶ 85))

SBC and Ameritech are clearly both of the belief that the continued growth of their businesses requires expansion into new markets outside of their traditional territories. It is equally clear that the first preference for each company is expansion through merger. The relevant inquiry here, however, is what strategies the companies might pursue if their proposed merger were blocked, and mergers with other RBOCs prohibited. It seems most likely that the companies would explore other methods of expansion. Drs. Rosston and Mercurio have calculated that it would require only about a 3.3% increase in SBC's overall annual capital budget of approximately $6 billion to fund the $200 million average annual capital budget of the NLS, so a comparable plan does not appear out of reach for the company on a stand-alone basis. Ameritech could certainly continue its own Follow-the-Customer plan. It seems most unlikely that the companies would not do anything to expand into local exchange markets outside their territories if the merger were blocked.

While we are unable to quantify the amount of such out-of-region competition or assess the magnitude of its likely effect, we are confident that, if the merger is blocked, it would offset to some extent the loss to residential out-of-region competition that would result from termination of the Local National Strategy as described by Applicants. We cannot say that blocking this merger would have no adverse consequences on the development of local exchange competition. However, the extent of the loss is necessarily speculative at this point, and would be balanced to some extent by the competitive initiatives that SBC and Ameritech would surely adopt in recognition of the fact that "[i]n order to compete successfully and thrive in this new telecom marketplace, a stand-alone and static strategy is . . . no longer viable." (Kahan Aff., ¶22)

IV. CONCLUSION AND RECOMMENDATION

As explained in section VI of the Rosston-Mercurio report, the significant competitive problems the proposed merger raises are attributable to the impoverished state of local exchange competition in the territories of Ameritech and SBC. The loss of Ameritech as a potential competitor in St. Louis, for example, would not be significant if the residential local exchange market in St. Louis were vibrantly competitive today. Similarly, the effect of the merger on diminishing the utility of benchmark regulation would not be a matter of concern if there were sufficient competition to render benchmark regulation unnecessary.

The conclusion to be drawn from these facts is that the proposed merger is premature. The undeveloped state of competition in local exchange markets precludes any confident conclusion that this merger does not present serious competitive problems. RBOCs could well be uniquely advantaged potential competitors into each other's territory. It is also not clear how significant benchmark regulation will continue to be as competition in local exchange markets develops at whatever pace it does in the years ahead.

A reasonable response to this situation is for the Commission to deny the application for transfer of licenses and invite SBC and Ameritech to reapply for license transfer approval after competition has had a reasonable amount of additional time to develop in their territories. The objections to this, of course, are that blocking the merger outright sacrifices whatever public interest benefits the merger would engender, and that the same uncertainty that counsels restraint in approving the merger likewise cautions concern about an outright prohibition.

As an alternative, the Commission could impose ex ante conditions on merger approval that provide direct incentives to the parties to hasten the development of competition in their territories. It appears that the best way to do this, and in a manner that is consistent with the parties' NLS plans, is to require the companies to win § 271 approval for the majority of the states in their combined territories (including states from both Ameritech's and SBC's regions) before the parties can consummate the merger and combine their operations.

There are several advantages to this approach. First, it imposes a requirement that is directly responsive to the competitive conditions that prompt reasonable reservations about merger approval. Second, the approach relies upon an established regulatory process for determining whether the preconditions to completion of the merger have been satisfied. Third, it provides strong incentives for the companies to complete the market-opening obligations imposed on them by the Telecommunications Act of 1996. Fourth, imposing a requirement that must be satisfied before the merger may be completed avoids the difficult enforcement problems created by post-merger conditions and requires no additional regulatory oversight. Finally, the approach makes completion of the merger turn upon an accomplishment – qualifying for the provision of in-region long distance service – that the parties have identified as a necessary prerequisite for the success of their National Local Strategy.

On balance, imposing the precondition is preferable to outright rejection of the merger. The Attorneys General therefore recommend that the Commission attach as a condition to any approval of the merger that Ameritech and SBC be prohibited from consummating their merger until they have won section 271 approval for a majority of their combined states, including states in both of their territories.

Respectfully submitted,

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