III. Benchmark regulation

The FCC and state public utility commissions regulate prices, offerings, and conduct of all local exchange carriers. They have additional regulatory oversight concerning the behavior of ILECs because of their market power.

Regulation has evolved from traditional rate of return regulation of a single monopoly firm (AT&T) to more incentive-based regulation of many ILECs dominant in their own local markets. The goal of incentive regulation is to avoid the inefficiency created by rate of return regulation. Incentive regulation is designed to create incentives for firms to operate efficiently and to invest in and introduce new products.

While incentive-based regulation is designed with these beneficial properties, there is still significant room for firms to influence the regulatory process with their own actions and information. First, incentive regulation is not implemented in its theoretical ideal – regulators have not committed to a long term hands-off approach. In the current regulatory scheme, low-end adjustment factors and sharing provisions contribute to impurities in price cap regulation.[26] Even more important, however, is the fact that price regulation is not the only form of regulatory oversight. Many of the regulatory disputes that have arisen in the telecommunications industry in recent years concern ILEC interactions with competitors and focus on actions (or inaction) rather than on prices. The issues that regulators have been concerned with include technically feasible

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[26] The FCC adopted the LEC Price Cap Order in 1990 (Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313. This plan included a scheduled review in 1994. The review and changes to the program were completed in 1995 (Price Cap Performance Review for Local Exchange Carriers, CC Docket 94-1, First Report and Order.) This plan was revised in 1997 (Price Cap Performance Review for Local Exchange Carriers, CC Docket 94-1, Fourth Report and Order). There is currently a new notice for additional changes to the price cap plan. This could lead to the fourth different price cap plan in less than 10 years, hardly a "hands-off" program.

interconnection, access to OSS functions, availability and feasibility of shared transport, open network architecture, collocation, equal access, overhead allocation, and performance standards.

Resolution of these issues involves setting requirements or performance standards for ILECs. These requirements are set with significant uncertainty because regulators have to act with incomplete information. Often even the firms subject to the requirements do not have a complete understanding of their costs or the capabilities needed to satisfy them. Because of this, there is a tendency for regulators to adopt a "safe" strategy, out of fear that excessively burdensome regulation might put a firm in financial peril and uncertainty over what level of regulation is excessively burdensome.

As Farrell and Mitchell[27] illustrate, a reduction in the number of independent observations increases the uncertainty facing regulators. With an increase in uncertainty, the regulator may tend to err further on the side of less restrictive regulations that can harm competition while benefiting ILECs. This is especially true when an issue involves questions of technical feasibility. Losing one observation could eliminate the single observation that proves that a particular interconnection agreement is feasible.

With the introduction of competitive local exchange providers, there have been a large number of disputes about what is or is not feasible and/or required by the law. In many cases, the RBOCs have come to very different conclusions. Sometimes this is due to differing interpretations of the law. In other cases it is because they have different long term views of their competitive strategies and vulnerability to competition or different characteristics of the customers and geography they serve.

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[27] Declaration of Joseph Farrell and Bridger M. Mitchell. "Benchmarking and the Effects of ILEC Mergers", October 14, 1998.

Recently, for example, the FCC determined that a particular LEC's physical collocation tariff was unreasonable by examining whether that tariff substantially deviated from averages of the tariffs submitted by all LECs.[28] The U.S. Court of Appeals recently upheld the FCC collocation rules using industry wide averages to establish interim rates.[29] The FCC also uses industry wide measures for the productivity adjustment factor for price cap LECs. The Commission has concluded that "benchmarking promotes the Commission's uniform reporting goals and is indispensable in monitoring the impact of price cap regulation on ILEC service quality and infrastructure development."[30] If the base of *independent* observations is reduced, it creates incentives for cost misallocation by regulated companies that price caps were intended to mitigate.

The FCC noted the reliance on benchmark regulation and standards in its Bell Atlantic/Nynex order. The following provides a brief re-cap of the evidence in that orders. The DOJ, the Courts, and the Bell Companies themselves have used the argument that the number of independent RBOCs helps regulators in detecting competitive abuses.[31] DOJ used the RBOC structure in assessing the non-discrimination requirements.[32] In 1991, the U.S. Court of Appeals for the District of Columbia Circuit wrote:

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[28] *Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection Through Physical Collocation for Special Access and Switched Transport*, Second Report & Order, FCC 97-208 ¶¶ 143, 146 (June 13, 1997).

[29] Communications Daily, March 22, 1999, page 6.

[30] In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Access Charge Reform, CC Docket No. 96-262, <u>Fourth Report and Order In CC Docket No. 94-1 and Second Report and Order In CC Docket No. 96-262,</u> Adopted: May 7, 1997; Released: May 21, 1997.

[31] Peter W. Huber, United States Department of Justice, Antitrust Division, *The Geodesic Network: 1987 Report on Competition in the Telephone Industry* 3.54-3.55 (1987). The issue of the number of Bell Companies was not discussed to any significant degree in either the MFJ or in the District Court's opinion approving the Bell System Plan of Reorganization. *See United States v. AT&T*, 552 F. Supp. 131 (D.D.C.

"There is a lot of evidence that the break-up and other recent developments have enhanced regulatory capability. . . . [T]he existence of seven [R]BOCs increases the number of benchmarks that can be used by regulators to detect discriminatory pricing. . . . Indeed, federal and state regulators have in fact used such benchmarks in evaluating compliance with equal access requirements . . . and in comparing installation and maintenance practices for customer premises equipment.[33]

All of the RBOCs, including Ameritech and SBC have in the past emphasized the importance of benchmarks for regulators. In various filings between 1987 and 1994, all of the RBOCs stressed that discrimination would be easily detectable because of the presence of other RBOCs to serve as points of comparison.[34]

State commissions have also relied on benchmarks. For example, in determining the details of interconnection agreements between Ameritech and AT&T and MCI, the Illinois Commerce Commission stated:

"The Commission also rejects Ameritech's concerns as to the technical feasibility of providing billing information to CLECs in order for them to bill IXCs for terminating access under Staff and intervenors' definition of common transport. The Commission agrees with AT&T and MCI that it is indeed technically feasible for Ameritech to provide information to CLECs on a daily and monthly basis sufficient to allow UNE subscribers

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1982); *United States v. Western Elec. Co.*, 569 F. Supp. 1057 (D.D.C.), *affirmed sub nom. California v. United States*, 464 U.S. 1013 (1983).

[32] *United States v. Western Electric Co.*, 47 Fed. Reg. 7170, 7174-5 (Feb. 17, 1982) (United States Department of Justice, Competitive Impact Statement). In addition, Peter W. Huber, in his 1987 report as a consultant to the Department of Justice, observed that reliance on benchmarking also improved the Commission's regulation of interconnection and monitoring of network performance: "Benchmarking one LEC's performance against another in the post-divestiture marketplace has proved an effective regulatory tool. Laggard or eccentric LEC performance stands out when eight large holding companies line up for periodic regulatory inspection. . . . In the three years since divestiture the FCC has thus had recent occasion to use highest-common-denominator regulation among the LECs." The report cites a plan by Ameritech to introduce "Feature Node Service Interface" interconnection to their switches, which triggered the Commission to require "open architecture" proposals from other Bell Companies. Peter W. Huber, *The Geodesic Network*, *supra*, at § 3.24 & n.84.

[33] *United States v. Western Elec. Co.*, 993 F.2d 1572, 1580 (D.C. Cir.), *cert. denied,* 126 L. Ed. 2d 438 (1993).

[34] See paragraph 149 of the Applications of NYNEX Corporation, Transferor, and Bell Atlantic Corporation, Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, Docket 97-286, Memorandum Opinion and Order Adopted: August 14, 1997.

> to bill IXCs terminating carrier access charges. The Commission finds it quite instructive that many other RBOCs have voluntarily agreed to or have been ordered by state commissions to provide such information."[35]

Different behavior by different RBOCs should be important to regulators. Nevertheless, these differences raise two issues. The first is that differences in networks, demand, and other factors might be so important that benchmarks are useless. Given the similar network design and relatively standardized operating systems of the RBOCs, it is difficult to accept this claim with regard to technical feasibility. For example, if it is feasible to provide common transport in one area, then the network differences currently are almost certainly not so great that common transport cannot be provided elsewhere. Indeed, the FCC has stated:

> "While we acknowledge that differences in the ILECs' operations may be explained in part by variations in carriers' service quality and infrastructure data, we conclude that benchmarking best serves the public interest and allows for the Commission and public to identify potential problem areas in quality of ILEC service."[36]

The second issue is that these differences in incentives provide regulators with additional information they can use to do their job more efficiently. Because of different approaches, ILECs have made different decisions and the resulting actions may reveal additional information to the regulator. Such additional information enables the regulator to make more informed decisions that can lead to a more competitive local exchange.

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[35] *Investigation into forward looking cost studies and rates of Ameritech Illinois for interconnection, network elements, transport and termination of traffic . . .*, ICC Docket Nos. 96-0486/96-0569 (Consol.), Second Interim Order at 115, February 17, 1998 (emphasis added).

[36] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers CC Docket No. 87-313 and AAD 97-28, Amendment of Part 61 of the Commission's Rules to Require Quality of Service Standards in Local Exchange Carrier Tariffs, Memorandum Opinion and Order Adopted May 14, 1997; Released May 30, 1997.

III.A Large ILECs are Important Sources of Benchmark Information

While there are on the order of 1500 different ILECs in the country, the number of large independent ILECs is much more important from a benchmarking standpoint. The vast majority of ILECs are not subject to the same interconnection requirements as the RBOCs so they are generally not in a position to provide a benchmark on interconnection issues.[37]

Second, the vast majority of access lines are controlled by the RBOCs and GTE so that the effect they have on competition is likely to be substantially greater than the effect of any small ILEC.

Finally, the large ILECs may be sufficiently different than other ILECs that comparisons with smaller firms may not provide useful information. In fact, the FCC often differentiates between large ILECs and small ILECs. For example, ARMIS reporting requirement differentiate between tier I and tier II ILECs, price caps are applied only to certain ILECs, and the x-factor was determined based only on large ILEC data.

III.B The Number of Independent RBOCs Matters

The parties argue that the number of observations for benchmarking purposes will not be reduced by the merger because each RBOC reports results on an operating company basis rather than on a holding company basis. The details of the reporting are obviously true. But the fact is that they will no longer be independent observations, but

[37] §251(f) provides exemptions from the general obligations on incumbent local exchange providers for small incumbents.

rather parts of the same whole. This is likely to be true both for regulatory reporting requirements and for CLEC comparisons.

Not only will regulators and competitors have less certainty and less chance of an outlier, but the reduction in the number of RBOCs resulting from the merger will alter the incentives of all remaining RBOCs, not just SBC and Ameritech. They will have less fear that another RBOC will become an outlier and they may realize more the effects of their actions on each other's incentives and have less incentive to become the outlier themselves. This concern is akin to the recognition of mutual interdependence in an oligopoly. However, in this case, the interdependent competitors act to reduce knowledge of what is capable of being done rather than the degree of price competition.

III.C Competitors use Benchmarks to Ensure Competitive Treatment

It is not just the FCC that uses RBOCs' actions as benchmarks. New entrants have been dealing with multiple RBOCs and have been able to learn from their different experiences about what is and is not feasible. For example, Northpoint Communications has compared the treatment it receives from RBOCs in its attempts to provide DSL services.[38] These comparisons showed very different terms, conditions, pricing and representations about feasibility from the different RBOCs. Depending on the feature or service demanded, different RBOCs were more or less willing to make it available. The divergence in the RBOCs behavior allowed Northpoint to show that at times Ameritech, Bell Atlantic, SBC, or BellSouth provided the best service and most reasonable terms.

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[38] *Ex parte* letter from Steven Gorosh, Northpoint Communications, July 7, 1998 in Dockets 98-11, 98-26, 98-32 and 98-91.

These observations allowed Northpoint to use its own form of benchmark both in its own negotiations as well as in its advocacy before regulatory agencies. At other times, Northpoint found that the "best" companies on one parameter provided subpar service compared to other RBOCs on other features. MCI WorldCom also uses the different behavior by RBOCs in its negotiations to understand what are technically feasible or reasonable ways to provision and price services.[39]

AT&T has submitted a letter from Judge Robert Bork that describes a number of AT&T's experiences where benchmarking has been useful in trying to compete in the local exchange.[40] For example, he discusses the problem of shared transport where Ameritech claimed its switches were incapable of measuring traffic on shared transport trunks. AT&T was able to use the fact that other RBOCs, including SBC, had made shared transport available. Cageless collocation has also been a significant concern of CLECs and ILECs. Almost all of the RBOCs have demanded expensive and time consuming buildouts of caged areas for collocation equipment. However, US West has worked with CLECs to come up with arrangements for much less expensive collocation arrangements that do not endanger the security of the network.[41]

Judge Bork describes seven other instances where AT&T has been able to use benchmarking arguments either in its negotiations with RBOCs or in regulatory proceedings. Often in these cases, there has been a single RBOC to which AT&T can point. In addition, it may be possible that there are other cases that did not arise because

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[39] *See* Joint Declaration of Michael A. Beach and Therese K. Fauerbach in Support of Comments of MCI Worldcom, Inc., CC Docket No. 98-141, October 14, 1998.
[40] *Ex parte* letter from Robert H. Bork to Chairman William E. Kennard, April 7, 1999.
[41] It is interesting to note the parallel between the network integrity arguments about collocation and the pre breakup network integrity arguments raised by the Bell System in the Carter Phone and Hush-a-phone cases.

the fear of being exposed by another firm as the benchmark. The loss of a benchmark through merger can lead to a reduction in the level of competition and ultimately harm consumers.

III.D A Single Observation May be Important to Competition

In most of the cases cited by competitors, a single RBOC did things differently than the others. The fact that there was one firm that differed from the others provided a significant amount of information to competitors and regulators. In different cases different firms were the ones that provided the benchmark. There is no way for the FCC, state regulators or competitors to know which firm will provide the next benchmark to hold up as the example of what is possible. Because of the uncertainty and loss in variety, a merger may result in a significant reduction in benchmarking ability for regulators and competitive firms.

III.E Benchmarks May be Especially Important with the Introduction of New Services

Benchmarks may be especially important when regulatory issues arise regarding the introduction of new services. Without benchmarks, the asymmetric information problem raises more concern. Regulatory uncertainty over disputes about how interconnection agreements govern the use of current technology is far less than the uncertainty over disputes about requiring an RBOC to accommodate a CLEC's unproven new technology for future services.

It should be noted that the value of benchmark information is reduced by the fact that the RBOCs do not have identical networks, demand, or preferences. Because of these differences, they will have different rates of introduction of new services and different willingnesses to deal with CLECs who want to use ILEC networks to introduce their own new services. As network differences increase, the ability to use one RBOC as a benchmark for the others may diminish.

As a result, firms will have more ability to stonewall regulators and competitors about the technical feasibility of new offerings. When a "renegade" or "maverick" RBOC accommodates such new services, a regulator feels more comfortable in requiring other firms to make similar capabilities available, and competitors are in a much better negotiating position when requesting such capabilities.[42] In fact, GTE made similar arguments about the benefits of a "maverick" firm in its opposition to the MCI WorldCom merger.[43] In those comments, GTE argued that the removal of a maverick firm could significantly reduce the competitiveness of the long distance industry because customers would not be able to benefit from this firm's independent behavior. The argument is similar in the context of the local exchange.

Clearly there will be regulatory oversight and independent firms examining the behavior of the RBOCs whether or not the merger is approved. But regulation is imperfect. The merger will further reduce the precision of regulation, especially with

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[42] It is not important that a single firm be the "maverick," but that for each service there is the possibility that some RBOC behave differently than the others.

[43] "By dramatically increasing concentration in the industry and altering the incentives of the only most significant participant that acts as a "maverick" (WorldCom), the merger of MCI and WorldCom would be directly antithetical to the interests of all retail consumers of long distance services." In the Matter of Applications of WorldCom, Inc. and MCI Communications Corporation, CC Docket No. 97-211 for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., Petition to Deny of GTE Service Corp. and its Affiliated Telecommunication Companies.

regard to the introduction of new services by competitors, where a regulator's uncertainty is greatest.

IV. Increased Incentives and Abilities For the RBOCs to Raise and Maintain Barriers to Entry

Currently, CLECs must interconnect with the ILEC's local networks to connect with the vast of majority their customers. In addition, many new entrants are relying on the incumbents to provide access to unbundled network elements (UNE), particularly unbundled loops, in order to reach customers. CLECs' reliance on incumbents for interconnection and unbundled elements means that new competitors are also customers of the ILECs.

In general, such competitor/customer relationships do not cause significant concern because they arise in marketplaces where none of the incumbents can exercise market power. In other words, there are generally alternatives for the inputs purchased from competitors that serve to protect customers from abuse. However, when incumbents possess a significant degree of market power held by a supplier/competitor, the risk of anticompetitive behavior increases.

In this case, SBC and Ameritech control a significant share of the access lines in their territories (See Section II above). If entry were easy and did not require interconnection with the ILEC network, then even a high market share of access lines might not cause concern. However, entry has not proven to be rapid, and it clearly requires interconnection with the ILEC network.

In analyzing the merger, it is important not only to consider existing barriers to entry and the current extent of CLEC reliance on the ILEC networks, but also to look at how the merger would change the balance of these relationships. For example, if the barriers to entry are already at their maximum levels, then it may be the case that the merger causes no additional concern.

As a result, an analysis of the merger should examine whether it increases both the *incentives* and *ability* of the merged firm to increase and maintain barriers to entry. Katz and Salop provide the logical underpinnings for why the merger might increase these incentives and abilities. The following paragraphs summarize their argument.

New entrants currently rely on ILECs for interconnection and UNEs. Looking forward, CLECs may need more cooperation from ILECs for the introduction of new services. But each ILEC individually has an incentive to slow the advance of competition, since each ILEC currently has market power in its own region and hopes to protect its position.

Currently, no ILEC is able to capture the full anticompetitive benefits that result from actions they take to block or deter new entrants. For example, Ameritech creates "spillover" benefits for SBC when it slows entry in Chicago in two ways. First, firms contemplating national entry strategies may abandon or scale back those strategies as a result of Ameritech's recalcitrance, thereby reducing entry in Dallas. This would be more likely to occur if a firm were near the edge of profitability, or if it needed a nationwide network of comparable quality to introduce its services. Second, entry deterrence in Chicago may impair entry in Dallas because it would reduce the ability of an entrant to compare the differences in services available from Ameritech and SBC. In this way entry could be slowed for all entrants seeking to enter Dallas who might use other markets as baseline comparisons.

With the merger, the firms would control more total access lines. Prior to the merger, Ameritech would not take into account the "benefits" to SBC of entry deterrence in Chicago. As a result, its incentive to deter to entry would be less than if it could internalize this externality. Therefore, one would expect that, at the margin, Ameritech's efforts to slow entry would increase once it begins to realize the benefits of entry reduction in SBC territory.

This argument assumes that regulation is insufficient to prevent abuses. Regulation is important in the telecommunications sector, and both the FCC and state regulatory agencies oversee ILEC behavior, with the assistance of competitors. Critics of the Katz/Salop argument have raised the point that in order for this theory to hold, the behavior has to be obvious to customers, but opaque to regulators. Katz explained in the FCC forum that this is not quite true.[44] Regulation of behavior is not a black and white, zero/one issue. There is a large amount of discretion in the application of regulatory sanctions. As long as there is room to move along the continuum and there is some regulatory uncertainty, the incentive will exist and the smart consumer/dumb regulator story does not have to hold. Prior to the merger, each firm would equate the marginal benefit and marginal cost of additional entry deterrence. The merger increases the

[44] "What regulators have to concern themselves with is why is it happening, and that is not something consumers care about. No one is going to go to Sprint or AT&T or MCI and say, you know, your service is really terrible, but since you have explained to me that you believe it is actually Bell Atlantic's fault, we will stick with you. Okay. It is not going to work that way, but that is the kind of thing that regulators have to look at that, and I think that is the really hard problem that is inherent in this and that makes it difficult and in fact impossible for regulation to fully constrain ILEC market power. I think really this is just a corollary to the existence of market power." Comments of Michael Katz from Written transcript of FCC Roundtable on the Economics of Mergers Between Large ILECS, Friday, February 5, 1999, The Commission Meeting Room, The Portals II, 445 12th St. S.W., Washington, DC.

marginal benefits from entry deterrence (and reduces the expected marginal cost) so the merged firm has incentives to increase entry deterrence.

The next step in the analysis is to explore whether evidence from other markets supports the Katz/Salop theory. Rich Gilbert makes the observation that there are few reported problems in intraLATA toll, where the ILEC almost always controls both ends of the call.[45] In fact, he argues that ILEC share of 50% of intraLATA toll is strong evidence that competition for intraLATA toll has not been impaired the way Katz and Salop predict. But this example is not as compelling as Gilbert suggests. It has taken a long time for the ILEC share of intraLATA toll to decline to 50%, and there have been substantial barriers to intraLATA toll competition such as a lack of dialing parity that have only been addressed through regulation.[46] In addition, discrimination may be less likely in intraLATA toll for at least three reasons. First, IXC intraLATA traffic is co-mingled with its interLATA traffic so that ILEC discrimination would have to affect all of the ILEC's customers' traffic, not just the intraLATA traffic. Because RBOCs cannot currently compete for interLATA service, discrimination would hurt their IXC customers and reduce demand for their access services. Second, discrimination in intraLATA toll would negatively affect RBOC efforts to enter the interLATA business so they have more incentive to cooperate. Third, the technology for long distance interconnection is better settled than local interconnection and collocation so the opportunities for harming competitors are smaller.

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[45] Written transcript of Written transcript of FCC Roundtable on the Economics of Mergers Between Large ILECS, Friday, February 5, 1999, The Commission Meeting Room, The Portals II, 445 12th St. S.W., Washington, DC.

[46] In fact, it was only in the last week that the Michigan PSC required Ameritech to provide intraLATA dialing parity in Detroit. *NECA Washington Watch*, April 14, 1999.

The intraLATA toll argument is important to consider. It shows that with standard interconnection arrangements, there might be less chance for discrimination. However, it misses the most important point of the discrimination argument. With technological change, new interconnection arrangements and/or unbundled element arrangements will be needed. This will require more cooperation from ILECs. It is precisely these types of negotiations where entry deterrence is most likely to be a competitive and regulatory concern. These types of situations are the ones where regulatory uncertainty is likely to be greatest.

If a new entrant develops a new service in advance of an ILEC that is planning to offer the same service in the future, or a new service that provides significant competition to an existing ILEC service that generates high margins, the ILEC may be able to use its control of key inputs to slow down its competitor. These incentives exist with or without the merger. According to the Katz/Salop theory, the merger will increase these incentives at the margin. This is because the larger footprint will enable the ILEC to internalize a greater portion of the spillover benefits of frustrating competition.

The next step in the Katz/Salop theory is to consider whether the *ability* to engage in discrimination would increase with the merger. Because a request for interconnection to support new services typically has more technical issues, regulators will be less able to state unequivocally that certain arrangements can or should be done. As a result, the ILEC's ability at the margin to harm competitors will increase because the "gray area" for the regulator has increased. This gives the ILEC more leeway to claim that arrangements requested by the new entrant are not feasible or technically possible. This uncertainty is present with or without the merger. The theory says is that the merger will increase the degree of uncertainty and hence the ability of ILECs to harm competitors.

Absent the merger, the regulator will have more independent observations to use to determine whether a particular arrangement is possible. With the merger, the number of independent observations declines and the regulator has less confidence, hence the ability to engage in discrimination increases.

The "Big Footprint" theory of competitive harm from the merger raises serious questions for regulators. Two major questions are the expected magnitude of the anticompetitive effects and the ability of regulators to detect and prevent abuses. If the FCC thinks that it and state regulators can vigilantly police discrimination efforts, this should also provide little additional concern. Similarly, concerns are lessened if the FCC finds that the marginal incentive effects from the merger are small.

Unfortunately, especially with respect to the introduction of new services, there is currently little if any empirical evidence with which to assess the magnitude of the changed incentives due to the merger.[47] This is partly because there has been relatively little time since the introduction of the Act and the large ILEC mergers. It is also because successful discrimination against national CLECs would affect entry decisions in areas served by both large and small ILECs so that differences might not be discernable. The FCC should consider whether there might be other ways to measure or prevent this effect since the theory is clear that the direction of the impact is to harm competition.

[47] Hayes, Jayaratne, and Katz have submitted a paper to which Carlton and Sider have responded concerning these empirical effects. Although both papers provide interesting points, neither paper settles the issue.

V. National/local strategy: Efficiencies That are Unique to the Merger?

Ameritech and SBC tout the benefits of their "National-Local Strategy" (NLS). According to the companies, if they are allowed to merge, they will implement the NLS to enter 30 of the top out-of-region markets. This will be a large scale effort that the parties promise will create competition in those out-of-region markets and will also cause other ILECs to retaliate against Ameritech and SBC. As a result, they argue the NLS will not only increase out-of-region competition, but will stimulate in-region competition as well. The parties also claim that these benefits will not be realized absent the merger because the endeavor is too expensive and risky for either to undertake on its own.

These claims need to be compared to an appropriate baseline. For purposes of the public interest analysis, the relevant comparison is not what the firms are currently doing, but what they could reasonably be expected to do absent the merger.

This section of the paper assesses the likelihood that either Ameritech or SBC or both would adopt a strategy similar to the NLS absent the merger, as well as the credibility of the claimed in-region benefits. There is little doubt that additional competition out-of-region will be beneficial to out-of-region consumers, but these benefits need to be compared with what might happen in the absence of the merger.

Generally, in antitrust law, efficiencies are not counted as a benefit unless they are merger specific. The 1997 'Efficiencies Revision' to the DOJ/FTC Horizontal Merger Guidelines states:

> "The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific

efficiencies.[48] Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical."[49]

V.A. The Firms would Likely Enter Out-of-region Absent the Merger

Ameritech and SBC claim that the NLS is necessary to protect their existing subscriber base from competitive entry. In particular, they claim that national entrants who can offer ubiquitous one-stop shopping will aggressively target their largest customers who contribute a disproportionate amount of revenues and bottom line profits. Left unchecked, these competitive losses will cause serious harm to the viability of the companies.

To counter this danger, the NLS contemplates entry into out-of-region markets. The companies plan to start with resale and unbundled network elements moving to facilities-based networks as demand justifies. This entry strategy is similar to the strategy that many CLECs are following. They are using collocation and unbundled elements while they build out their own facilities. The major difference appears to be the "follow me" strategy of the NLS and the identity of the competitor. CLECs have no embedded local customers to follow in the same way. To the extent that the NLS allows customers to buy all of their service from one provider, and they value this service, it will benefit customers. But it is also likely that CLECs would offer similar bundles of services if customers valued it.

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[48] The Agency will not deem efficiencies to be merger-specific if they could be preserved by practical alternatives that mitigate competitive concerns, such as divestiture or licensing. If a merger affects not whether but only when an efficiency would be achieved, only the timing advantage is a merger-specific efficiency.

[49] Revised Section 4 Horizontal Merger Guidelines Issued by the U.S. Department of Justice and the Federal Trade Commission, April 8, 1997.

SBC conducted a survey of customers who switched to CLECs.[50] The main survey question was "Why did they Switch?" Price was by far the number one answer at 72%. Only 13% of the customers switched for the convenience of one-stop shopping. This indicates that the need for the NLS may be less in the eyes of the customer than in the providers, although other surveys indicate otherwise. In addition, these customers were the "early adopters" of CLECs. If marginal customers are significantly different from the early adopters, the value of one stop shopping may be higher. Ameritech also conducted a marketing survey of potential customers for their proposed out-of-region entry into St. Louis. The results indicate that "Integration is market-driven, not customer-driven" and "Consumers are not looking primarily for increased competition or for integration. They are looking for remedies to service-specific complaints."[51]

CLEC experience to date has shown that entry into the local exchange market cannot be achieved rapidly. Three years after the enactment of the Telecommunications Act, CLECs have garnered only about 5% of the local exchange revenues, and a large portion of that is paid back to ILECs for use of their facilities through resale or UNEs. Based on these experiences, one should not expect the NLS out-of-region entry to be rapid, although there is the hope that the unique local exchange skills of the two companies can change the speed of the entry process.

To assess what would happen absent the merger, one needs to incorporate two pieces of information: that the NLS is designed to prevent competitive losses from national one-stop shopping providers and that out-of-region entry will take time. Absent

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[50] "Why did they Switch?", CLEC Customer Study - 5/98, Marketing Research & Analysis, SBCAMUS 026497.

[51] AIT0018414 and AIT0018415.

the merger, each firm alone will be subject to similar competitive CLEC entry.[52] As a result, if a large part of the base of large customers wanted one-stop shopping, each firm individually would have a strong incentive to provide the services demanded by its core customers.

How could the firms implement an out-of-region strategy without the other? One way would be for either company to replicate the NLS on its own. Clearly if there are significant economies of scale, this would be less efficient than the two companies implementing the strategy jointly. Also, it would require more cities because each firm would have to enter the other's region. But these expenses are not likely to be overwhelming for firms the size of Ameritech or SBC. In fact, James Kahan of SBC was quoted in the Indianapolis Star as saying that the capital investment associated with the NLS is "chump change."[53] In fact, the annual capital budget of the NLS is roughly $200 million dollars per year,[54] which is just a 3.3% increase above SBC's current overall annual capital budget of approximately $6 billion dollars.[55]

Dennis Carlton identifies a number of CLECs who have been actively trying to implement exactly the same type of out-of-region entry without nearly the same resources. For example, the market capitalization of NextLink is about $3 billion and e.spire is about $800 million. These firms do not have the large amounts of revenue to

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[52] In fact, if the Katz/Salop theory holds, the competitive pressure in-region would be even higher absent the merger so that the following argument would be even stronger.
[53] "SBC Won't Commit to Cost of Merger in State." *Indianapolis Star*, December 2, 1998.
[54] Affidavit of James S. Kahan, para. 57, FCC Docket 98-141, July 20, 1998 states "The National-Local Strategy calls for the investment of more than $2 billion in capital expenditures." The NLS projections cover a 10-year period, leading to the $200 million per year figure.
[55] SBC's 1998 Annual Report lists capital expenditures of 5.855 billion in 1996, 6.230 billion in 1997, and 5.927 billion in 1998.

protect so presumably have a smaller incentive to attract the large customers than the incumbents.

Because the attack on revenues would be the same or stronger in the absence of the merger, each firm alone would have incentives to pursue its own NLS absent the merger. The costs of the strategy are not sufficient to deter smaller, less well-capitalized firms from undertaking the same strategy. As a result, it appears that absent the merger, each firm would alone construct some out-of-region strategy to maintain its relationships with its best customers if indeed that is what is required to maintain those customers.

Ameritech had begun such a strategy with its "Managed Local Access" project. Ameritech was apparently going forward with a strategy that looks nearly identical to the National-Local strategy outlined by the merging parties. The company had begun the project and was approaching customers in early 1998. According to a slide from an Ameritech presentation, "Since February, CBS [Custom Business Services] has gained valuable MLA experience"[56] The slide goes on to state that 632 lines had been seamlessly migrated and more MLA deals were in the works. "More MLA deals have progressed through the sales process: Banc One, Comerica, Eaton Manufacturing, Kroger Foods."[57]

A marketing plan for MLA dated May 5, 1998 states under strengths: "The 'follow our customer' plan leverages our in region sales and marketing efforts and builds on our in region credibility with our customers as a preferred provider of LEC services."[58]

[56] AIT0287981.
[57] Id.
[58] AIT0291312

Finally, an undated presentation entitled "Ameritech GlobalDesk Managed Local Access Building Blocks for Better Customer Solutions" states " 'We deliver truly national coverage'"[59] and goes on to discuss the states where Ameritech can provide service. The document also claims that Ameritech is providing managed service to 24 customers and touts the company as "the most aggressive RBOC supporting national local exchange."[60]

It is clear that solo strategies may entail duplicative expenditures, which could increase costs. In general, in any competitive industry, firms make duplicative investments. The key is whether the magnitude of these costs are sufficiently high so as to increase prices over where they would be without the additional competition. In this case, given the possible entry strategies, it does not appear that if Ameritech and SBC were to enter separately that the magnitude of duplicative investment would be so high as to harm consumers.[61]

V.B. The NLS is Unlikely to Create Additional In-Region Competition

SBC and Ameritech claim that the NLS will promote in-region competition because of a "tit for tat" strategy by their out-of-region competitors:

> "Entry into out-of-region markets, a key element of the merger's business plan, likely will cause other telecommunications firms to enter the merged firm's territory with their own integrated services."[62]

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[59] AIT0291534
[60] Id.
[61] In fact, if one of the firms were to enter into a joint venture with one of the new CLECs, then there would be virtually no additional duplicative investment relative to the merged NLS.
[62] Affidavit of Richard J. Gilbert and Robert G. Harris on behalf of SBC Communications, July 21, 1998, para 28.

The theory is, for example, that if SBC-Ameritech begins competing in Bell Atlantic's region, this will encourage Bell Atlantic to attack SBC-Ameritech's region. While superficially appealing, this logic is exactly backwards. If it were true that absent the merger Ameritech would absolutely not compete in Bell Atlantic's territory, then Bell Atlantic would have incentive to enter Chicago first as it would know that there would be no retaliation. Instead, if there were a strong chance that the (merged) firm would retaliate, Bell Atlantic would consider this when making entry decisions and might enter Minneapolis, Cincinnati or Atlanta before entering Chicago. As a result, the increased potential for in-region competition touted by the parties is simply not logical.

One way in which the tit-for-tat strategy might be logical is if there is currently a tacit agreement among the large ILECs not to encroach into each others' territory. (This is obviously not a position that the parties advance.) If the NLS would cause such a détente to break down, it might create additional entry. Then if other large ILECs were better out-of-region local competitors than general CLECs, in-region benefits from this entry would be realized. Thus, the only way that the tit-for-tat retaliation can lead to consumer benefits is if ILECs are uniquely positioned potential entrants, a claim that was discussed earlier. If ILECs are uniquely positioned to create additional in-region competition, why would Ameritech-SBC want to unleash this force?

The NLS is unlikely to create additional in-region competition simply because of out-of-region entry by Ameritech-SBC. The claimed benefits from the NLS are either unlikely to emerge or would be realized absent the merger. As a result, they should not be considered to be additional public interest benefits resulting from the merger.

VI. Conditions May Ameliorate the Competitive Concerns and Promote Competition

There are several competitive concerns that arise from the proposed SBC/Ameritech merger: elimination of potential competition, reduction in available benchmarks, increased incentive and ability to discriminate, especially with respect to the introduction of new services, and an overstatement of the benefits from the National Local Strategy. These four areas of concern will all be mitigated at some point in the future when and if the local exchange market becomes workably competitive, i.e., when competitors are not reliant on the incumbent LECs for interconnection and unbundled elements.

The FCC should consider whether conditions can be imposed on any approval of the merger to ensure that it is in the public interest.[63] Any such conditions would have to address the four concerns. The best way to assuage these concerns would be through development of a competitive local exchange market. But local exchange markets currently are not effectively competitive, and they cannot be made so through regulatory fiat.

Under these circumstances, the Commission has several options. One would be to deny the merger application and invite the parties to reapply when local exchange markets are more competitive. A second option would be to condition approval of the merger on a prior showing modeled on DOJ 's interpretation of the §271 entry standard requiring that the local exchange market be "irreversibly open to competition." A third

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[63] See Letter from FCC Chairman William E. Kennard to Ed Whitacre and Richard Notebaert, April 2, 1999.

option would be to require other pro-competitive showings in advance of merger approval, such as built-out collocation cages available for competitors. Finally, the Commission could require *ex post* commitments to pro-competitive behavior as a condition of merger approval.

Denying the merger application would clearly solve the competitive concerns. However, this would also deny realization of the benefits of the merger. In addition, while it might provide some incentive to SBC and Ameritech to open their local markets to competition more aggressively in order to obtain approval of a re-submitted merger application, this incentive effect would not be very strong in the case of an outright denial. As a result, while it would ameliorate the competitive concerns raised by the merger, denial of the merger application would sacrifice the benefits of the merger and would squander the opportunity to provide a powerful incentive to Ameritech and SBC to aggressively open their markets to competition.

Conditioning approval of the merger on an adequate showing under §271 standards that SBC's and Ameritech's markets are irreversibly open to competition would be less effective than outright denial in addressing the competitive concerns the merger raises, but it would allow the merger to proceed. Such a condition, if satisfied, would still result in a reduction in benchmarks, and if competition does not develop rapidly, this may cause harm to consumers. In addition, CLECs would still be reliant upon ILECs for the access necessary for the introduction of new services. If large ILECs are the best potential entrants, the merger would eliminate one of the best potent sources of competition in SBC's and Ameritech's territories. But if it were shown that SBC's and Ameritech's markets were irreversibly open to competition, these concerns would be lessened.

A condition requiring §271 prior to merger approval would also create other incentive effects. It would obviously encourage the parties to put even more effort into obtaining §271 approval for the states they serve. If the entire effort were directed towards opening the market to efficient competition, this would be a boon to consumers. However, this type of condition would also likely have the undesirable side-effect of unleashing substantial efforts directed towards pressuring state and federal regulators to approve the §271 applications as rapidly as possible, rather than only when the markets are truly open.[64]

Imposing as a pre-condition of the merger that the parties irreversibly commit to additional, specific, concrete, pro-competitive actions, such as making available collocation space, might relieve some of the political pressure on regulators if the standards are objective and concrete. However, the appropriate standards may be difficult to determine. In addition, there remains the tradeoff discussed above that a more burdensome pre-condition could cause the parties to abandon the merger and any pro-competitive benefits that the merger or its approval would prompt.

The final type of condition that might be proposed is a commitment to open markets. This is the type of condition placed on the Bell Atlantic/NYNEX merger. There are three problems with this type of condition. First, the Bell Atlantic/NYNEX conditions essentially compelled compliance with section 251 of the Act, which was already required of the parties. Second, compliance with the conditions takes time and consumers and entrants bear the brunt of the time delay in this case. Third, *ex post* monitoring is required and this becomes a regulatory process in and of itself rather than

[64] It also may have the beneficial effect of lessening any pressure to unnecessarily delay 271 approvals.

the path to deregulation and competition. This is clearly demonstrated by the current FCC docket specifically concerning whether Bell Atlantic/NYNEX has lived up to its commitments.[65]

In light of these tradeoffs, it is clear that *ex post* commitments are not fully effective to remedy the competitive concerns raised by the merger, nor are they sufficient to create the pathway to a competitive marketplace. While there is the strong hope that the local exchange will shortly become a truly competitive marketplace with the introduction of competition from other facilities-based providers, it has not reached that level yet. The best way to get there is to ensure that competing providers have the ability to compete on a level playing field.

It is possible that denying the merger may get us to that point the soonest. But providing an incentive to the RBOCs to open their markets more quickly may increase the prospects of effective competition, even though it poses the risks discussed above. As a result, at a minimum, SBC and Ameritech should be required to obtain §271 approval in the majority if not all of their states in advance of approval of the merger.[66] Conditioning the merger on §271 approval in a single state or one state for each of the companies would be better than using "commitments," but it would not alleviate the competitive concerns discussed above and would not provide incentive for opening up of

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[65] FCC Docket DA 99-296, February 5, 1999, Commission Seeks Comment On Bell Atlantic's Progress Report On Compliance With Bell Atlantic/Nynex Merger Order Conditions. "Through this Public Notice, the Commission seeks comment regarding Bell Atlantic's compliance with the conditions imposed in the Bell Atlantic/NYNEX Merger Order. We invite parties to present their views on Bell Atlantic's progress report and the effectiveness of the Merger Order Conditions at promoting competition in the post-merger Bell Atlantic region."

[66] In implementing this requirement, the Commission should take note of the different OSS systems that Ameritech and SBC have offered to competitors. The incompatibility of these systems indicates that it would be reasonable not only to require that the companies be approved for § 271 entry in a majority of their states, but that at least one of the states be in the Ameritech region.

the majority of the markets the companies serve. In addition, approval in only one or two states would not allow the parties to move forward as rapidly with the promised benefits of the NLS.

The parties have asserted that one of the primary benefits of the merger is the National-Local Strategy. As a result, the §271 approval requirement should not be burdensome because it is essential to the fulfillment of that strategy. Since it will be impossible to require the firms to live up to the promises they have made regarding the competitive benefits of the NLS, requiring §271entry approval in advance of the merger forces the firms to take the first step toward fulfilling their claims in advance of the merger.

Requiring §271 approval in a majority of the parties' states in advance of the merger does not alleviate all of the competitive concerns that this merger raises. However, it does provide some basis for hope that a truly competitive marketplace will develop in the future, and at the same time it creates incentives for the parties to make good on their promises of pro-competitive benefits of the merger in-region and out-of-region. Finally, it is a requirement that is completely within the control of the parties to satisfy. If this is seen as too high a bar, that is simply because SBC and Ameritech have not yet taken the steps required of them for the last three years to open their local markets to competition.