

SIDLEY & AUSTIN
A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

CHICAGO
DALLAS
LOS ANGELES
NEW YORK

1722 EYE STREET, N.W.
WASHINGTON, D.C. 20006
TELEPHONE 202 736 8000
FACSIMILE 202 736 8711

FOUNDED 1866

HONG KONG
LONDON
SHANGHAI
SINGAPORE
TOKYO

WRITER'S DIRECT NUMBER
202-736-8236

WRITER'S E-MAIL ADDRESS
mhunsede@sidley.com

October 21, 1999

BY HAND DELIVERY

Ms. Magalie Roman Salas
Secretary
Office of the Secretary
Federal Communications Commission
Room TW-B-204
445 Twelfth Street, S.W.
Washington, D.C. 20008

Re: ERRATA FILING in CC Docket No. 99-295

Dear Ms. Salas:

On October 19, 1999, AT&T filed its Comments in Opposition to Bell Atlantic's Section 271 Application for New York in the above-captioned docket. Exhibit B to AT&T's Comments, the Affidavit of B. Douglas Bernheim, Janusz A. Ordovery, and Robert D. Willig, was missing several pages.

Please accept the attached Affidavit (plus six copies) as a replacement, which contains the missing pages. Because the attachments to the Affidavit were correct as initially submitted, I have not included them with this replacement copy.

As indicated below, I will be providing copies of this letter by first class mail to Ms. Janice Myles of the Commission's Policy and and Program Planning Division, to the Department of Justice, to the New York Public Service Commission, to ITS, and to Bell Atlantic's listed counsel.

No. of Copies rec'd 1 copy
List ABCDE

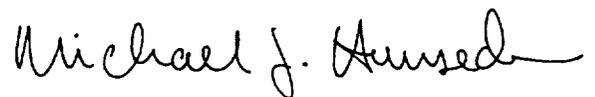
SIDLEY & AUSTIN

WASHINGTON, D.C.

Ms. Magalie Roman Salas
October 21, 1999
Page 2

Thank you for your attention to this matter. If you have any questions about this matter, please do not hesitate to contact me.

Sincerely,



Michael J. Hunseder

Enclosure

cc: Ms. Janice Myles, Federal Communications Commission (12 copies)
Donald J. Russell, Department of Justice
ITS, Inc.
Maureen Helmer, New York Public Service Commission
Michael Glover, Bell Atlantic
Randal Milch, Bell Atlantic
Mark L. Evans, Kellogg, Huber, Hansen, Todd & Evans
James G. Pachulski, Technet Law Group
James R. Young, Bell Atlantic

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

In the Matter of:

Application by Bell Atlantic New York)
For Authorization Under Section 271) CC Docket
Of the Communications Act to Provide) No. 99-295
In-Region, InterLATA Service)
In the State of New York)

OCT 22 1999

AFFIDAVIT

OF

B. DOUGLAS BERNHEIM,
JANUSZ A. ORDOVER AND ROBERT D. WILLIG

ON BEHALF OF

AT&T CORP.

AT&T EXHIBIT B

TABLE OF CONTENTS

	<u>Page</u>
I. AFFIANTS AND THEIR QUALIFICATIONS	1
A. B. Douglas Bernheim	1
B. Janusz A. Ordover	2
C. Robert D. Willig	4
II. OVERVIEW AND SUMMARY OF AFFIDAVIT	6
A. Section 271 and the “Public Interest” Standard	6
B. BA-NY's Public Interest Arguments	11
C. Main Conclusions	12
III. BA-NY CONTINUES TO HAVE MARKET POWER IN NEW YORK LOCAL EXCHANGE AND ACCESS MARKETS	13
IV. AN RBOC'S ENTRY INTO LONG DISTANCE WILL ADVERSELY AFFECT COMPETITION IF THE RBOC MAINTAINS MARKET POWER OVER LOCAL EXCHANGE AND ACCESS SERVICES	19
A. Leveraging of Local Market Power into the Long Distance Market	20
1. Incentives to Discriminate	20
2. Opportunities to Discriminate	23
a. Network Design	23
b. Service Availability	26
c. Pricing	29
d. Ancillary Services	31
e. IXC Relations	32
B. Harm to Local Competition	33
C. Cost Misallocation	37
V. PRESENT REGULATORY SAFEGUARDS HAVE NOT BEEN SHOWN TO BE EFFECTIVE IN CONSTRAINING BA-NY'S MARKET POWER	40
A. The Requisite Regulatory Safeguards Have Not Been Time Tested	40
B. Regulation Will Not Eliminate BA-NY's Incentive and Ability to Discriminate Against its Competitors	42
C. The Separate Affiliate Requirement Does Not Obviate Competitive Concerns	45

VI.	BECAUSE THE LONG DISTANCE MARKET IS ALREADY VIGOROUSLY COMPETITIVE, THERE IS NO BASIS FOR BA-NY'S CLAIMS OF SIGNIFICANT CONSUMER BENEFITS FROM ITS ENTRY	49
A.	Competitive Conditions in Long Distance	49
1.	There Are Over 1000 Firms Competing For Long Distance Services Customers.	50
2.	The Long Distance Market Is Characterized By Excess Capacity.	53
3.	Customer Churn Illustrates the Competitive Impact of New Entrants.	55
4.	Long Distance Prices Have Fallen Markedly.	55
5.	Discount Programs Indicate Intensity of IXC Competition.	56
6.	Barriers to Entry Are Minimal.	56
7.	Characteristics of Demand in the Long Distance Market Foster Competition.	57
8.	Long Distance Quality Has Improved.	59
B.	Responses To Bell Atlantic's Economists Concerning The Competitive State Of	59
1.	The State Of Competition In Long Distance	59
a.	Points Of Agreement	59
b.	Points Of Disagreement	61
2.	The Potential Pro-Competitive Effects Of BA-NY's Entry Into Long Distance	76
a.	Errors Pertaining To The Benefits Of New Service Offerings	77
b.	Errors Pertaining To Projected Effects On Prices	77
VII.	CONCLUSION	82

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

In the Matter of:

Application by Bell Atlantic New York)
For Authorization Under Section 271) . CC Docket
Of the Communications Act to Provide) No. 99-295
In-Region, InterLATA Service)
In the State of New York)

OCT 22 1999

AFFIDAVIT OF B. DOUGLAS BERNHEIM,
JANUSZ A. ORDOVER AND ROBERT D. WILLIG
ON BEHALF OF AT&T CORP.

Douglas Bernheim, Janusz A. Ordover and Robert D. Willig do hereby depose
and state as follows:

I. AFFIANTS AND THEIR QUALIFICATIONS

A. B. Douglas Bernheim

1. I am the Lewis and Virginia Eaton Professor of Economics at Stanford University. I received my Ph.D. from the Massachusetts Institute of Technology in September 1982, and my A.B. from Harvard University, *summa cum laude*, in June 1979. My previous academic appointments include an endowed chair in Economics and Business Policy at Princeton University, where I was also Co-Director of the Center for Economic Policy Studies, and an endowed chair in Risk Management at Northwestern University's J.L. Kellogg Graduate School of Management, Department of Finance. I have taught courses in Industrial

FCC DOCKET NO. 99-295

AFFIDAVIT OF B. DOUGLAS BERNHEIM, JANUSZ A. ORDOVER AND ROBERT D. WILLIG

Organization (Ph.D. level), Microeconomic Theory (Ph.D. level and undergraduate level), Public Finance (Ph.D. level and undergraduate level), and Insurance (Masters level).

2. I have published extensively in academic journals and elsewhere on topics in industrial organization, microeconomic theory, public finance, and other areas. I have received a number of awards and professional recognitions, including an Alfred P. Sloan Foundation Research Fellowship, and NBER-Olin Research Fellowship, election as a Fellow of the Econometric Society and election as a fellow of the American Academy of Arts and Sciences. I have served on the editorial boards of several professional journals, including *Econometrica*, *Quarterly Journal of Economics*, *Journal of Public Economics* and *Journal of Financial Intermediation*.

3. I have testified previously before Congress (Subcommittee on Social Security, Committee on Ways and Means, U.S. House of Representatives), and have been retained as a consultant and/or expert witness on matters of antitrust policy and regulation in numerous matters. I have conducted detailed studies of competition and market conditions in a variety of industries, and have sponsored testimony concerning these studies before a number of government agencies and judicial bodies, including the Federal Communications Commission, the Department of Justice, and the United States District Court for the District of Columbia. A copy of my *curriculum vitae* is appended hereto as Attachment 1.

B. Janusz A. Ordover

4. I am Professor of Economics and Director of the MA Program at New York University, which I joined in 1973. At New York University, I teach undergraduate and

doctoral level courses in industrial organization economics, the field of economics concerned with competition among business firms and upon which "antitrust economics" is founded. I have devoted most of my professional life to the study and teaching of industrial organization economics and to its application through antitrust and regulatory law and policy.

5. In July 1991, President George Bush appointed me to the position of Deputy Assistant Attorney General for Economics in the Antitrust Division of the United States Department of Justice. In this post, I participated in the drafting of the 1992 Horizontal Merger Guidelines, which have been widely used by courts and antitrust enforcement agencies. In addition, I led many merger reviews that employed and developed methodologies to define relevant markets in merger and other cases. I returned to New York University in 1993.

6. I have been actively involved in the formulation of public policy in the telecommunications sector. In particular, I have submitted written and oral testimony for AT&T to the Federal Communications Commission and to the state regulatory commissions in the Midwest, New England, and New York on a number of issues, including the pricing of unbundled network elements and access to bottleneck facilities.

7. I have written extensively on a wide range of antitrust and telecommunications topics, such as mergers and joint ventures, predatory conduct and entry barriers. My antitrust articles have appeared in the *Yale Law Journal*, the *Harvard Law Review*, the *Columbia Law Review*, and many other journals, monographs and books, here and abroad. A full list of my articles and other professional publications and activities is presented in my *curriculum vitae*, which is attached as Attachment 2.

8. I have lectured extensively on antitrust topics to the American Bar Association, the International Bar Association, and the Federal Trade Commission (FTC). I recently delivered lectures to the FTC during its hearings on the Future of Antitrust Enforcement, which were organized by FTC Chairman Robert Pitofsky. I have also lectured on antitrust policy at colleges and universities in the United States and abroad, and at many conferences and meetings sponsored by various legal organizations.

9. I have acted as a consultant on antitrust and other competition matters to the Department of Justice, the FTC, and the post-communist governments of Poland, Russia, and Hungary. I have also consulted for the World Bank and the Organization for Economic Cooperation and Development in Paris. I have acted as a consultant in numerous antitrust litigation and investigations, including market definition and anti-competitive conduct matters for the FTC, Department of Justice and private clients in the United States, Australia, Germany and the European Union. I have extensive experience in the analysis of competitive effects of business strategies, including tying and bundling.

C. Robert D. Willig

10. I am Professor of Economics and Public Affairs at the Woodrow Wilson School and the Economics Department of Princeton University, a position I have held since 1978. Before that, I was Supervisor in the Economics Research Department of Bell Laboratories. My teaching and research have specialized in the fields of industrial organization, government-business relations and welfare theory.

11. I served as Assistant Deputy Attorney General of Economics in the Antitrust Division of the United States Department of Justice from 1989 to 1991. I also served on the Defense Science Board task force on the antitrust aspects of defense industry consolidation and on the Governor of New Jersey's task force on the market pricing of electricity.

12. I am the author of *Welfare Analysis of Policies Affecting Prices and Products; Contestable Markets and the Theory of Industry Structure* (with W. Baumol and J. Panzar), and numerous articles, including "Merger Analysis, IO theory, and Merger Guidelines." I am also a co-editor of *The Handbook of Industrial Organization*, and have served on the editorial boards of the *American Economic Review*, the *Journal of Industrial Economics* and the MIT Press Series on regulation. I am an elected Fellow of the Econometric Society and an associate of The Center for International Studies.

13. I have been active in both theoretical and applied analysis of telecommunications issues. Since leaving Bell Laboratories, I have been a consultant to AT&T, Bell Atlantic, Telstra and New Zealand Telecom, and have testified before the U.S. Congress, the Federal Communications Commission, and the public utility commissions of about a dozen states. I have been on government and privately supported missions involving telecommunications throughout South America, Canada, Europe, and Asia. I have written and testified on such subjects within telecommunications as the scope of competition, end-user service pricing and costing, unbundled access arrangements and pricing, the design of regulation and methodologies for assessing what activities should be subject to regulation,

directory services, bypass arrangements, and network externalities and universal service. On other issues, I have worked as a consultant with the Federal Trade Commission, the Organization for Economic Cooperation and Development, the Inter-American Development Bank, the World Bank and various private clients. A full list of my articles and other professional publications and activities is presented in my *curriculum vitae*,¹ which is attached as Attachment 3.

II. OVERVIEW AND SUMMARY OF AFFIDAVIT

A. Section 271 and the “Public Interest” Standard

14. On September 29, 1999, Bell Atlantic - New York (“BA-NY”) filed an application pursuant to Section 271 of the Telecommunications Act of 1996 (“TA 96”) to provide in-region interLATA services in New York. Two economists filed affidavits in support of BA-NY's application.¹ We have been asked to review these affidavits and assess the validity of BA-NY's economists' arguments in support of the application.

15. TA 96 provides that an RBOC may apply at any time to provide in-region interLATA services to customers. It also establishes three basic preconditions for granting approval for such applications.

16. First, the RBOC must be providing access and interconnection to competitors pursuant to state-approved agreements. Under certain circumstances, the RBOC may seek authorization in the absence of such agreements, but must in that case show that it is

¹ Included in BA-NY's filings were the Declarations of William Taylor (“Taylor Dec.”) and Paul MacAvoy (“MacAvoy Dec.”).

making access and interconnection generally available to competitors. The provision or offering of access and interconnection within the state must further comply with a competitive checklist.

17. Second, the RBOC must show that it will comply with the non-discrimination and structural separation requirements set forth in TA 96. As explained by the FCC, in this context, “nondiscriminatory” provision applies not only “to the terms and conditions that an incumbent LEC imposes on third parties” but also proscribes certain self-preferential activities by an incumbent LEC. That is, in order to determine whether a RBOC complies with the nondiscrimination provision of TA 96, the regulator must be able to determine not only that the RBOC does not discriminate among third parties but also that it does not discriminate in the provision of these services in its own favor, or in favor of its subsidiary.

18. Third, the FCC must consult with the Department of Justice and determine whether the grant of the application is in the public interest. From an economic perspective, the public interest criterion for granting the application is satisfied if the potential benefits to telecommunications consumers from granting in-region interLATA relief likely exceed the potential consumer harms. This broad perspective dovetails with the FCC's rejection of prior RBOC arguments that the public interest test should be limited to an inquiry whether RBOC entry would enhance competition in the long distance market.²

² See, e.g., Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as Amended, To Provide In-Region, InterLATA Services in Michigan, CC Docket No. 97-137, ¶ 386 (August 19, 1997)(“Ameritech-Michigan”):

19. The most appropriate approach to the assessment of the competitive conditions that must be satisfied for the public interest to weigh in favor of granting interLATA relief is the *market power* approach, which conditions the removal of the interLATA ban on demonstrable absence of significant market power in the provision of local exchange services. The economic logic underlying the market-based approach is quite simple.

20. First, competitive markets are superior to regulation in disciplining the exercise of market power. Regulation is at best a necessary evil, which can never do more than approximate the performance of a competitive market. In practice, the results of such regulation are almost always markedly inferior to the outcome of unregulated competition. Perhaps the greatest deficiency of centralized regulation is the imperfect information available to the regulator. No centralized regulator -- no matter how intelligent, conscientious and well informed -- can approach the responsiveness and suppleness of the feedback loop known as the free market. Nor can any regulator approach the market's effectiveness in matching the wants and needs of consumers with the technology and resources available to producers, now and in the future.

“We reject the view that our responsibility to evaluate public interest concerns is limited narrowly to assessing whether BOC entry would enhance competition in the long distance market. We believe that our inquiry must be a broader one. The overriding goals of the 1996 Act are to open all telecommunications markets to competition by removing operational, economic and legal barriers to entry, and, ultimately, to replace government regulation of telecommunications markets with the discipline of the market.”

21. Second, the absence of significant market power in the local exchange would indicate that competition in the provision of local services has taken root, in accordance with the principles announced in TA 96. In identifying key components of the Section 271 public interest test, the Commission has emphasized the need for data demonstrating the erosion of the incumbent's market power across different classes of customers, in different geographic regions and across different scales of operation:

The most probative evidence that all entry strategies are available would be that new entrants are actually offering competitive local telecommunications services to different classes of customers (residential and business) through a variety of arrangements (that is, through resale, unbundled elements, interconnection with the incumbent's network, or some combination thereof), in different geographic regions (urban, suburban, and rural) in the relevant state, and at different scales of operation (small and large).³

22. Third, absent significant market power in the provision of local exchange services, including local access, an RBOC cannot successfully engage in anticompetitive conduct against its long-distance and local service rivals. The risks associated with premature RBOC entry into long distance are described in Section IV.

23. The evidence provided in this affidavit shows that BA-NY fails the market-based test. As described in greater detail below, even when all entry modes (including unbundled network elements ("UNEs") and resale) are taken into account, BA-NY serves about 91 percent of all access lines and over 95 percent of the residential access lines in its New York service territory. Even with respect to business customers, BA-NY still controls an overwhelming percentage of the market, serving over 83 percent of the business

³ Ameritech-Michigan, ¶ 391.

access lines in the state. Bell Atlantic's market power is confirmed by the fact that its rates for local service remain constrained, not by competition, but by regulatory price caps.

24. In the face of overwhelming evidence that BA-NY still enjoys market power in New York local exchange and access markets, BA-NY's economists base their arguments favoring interLATA relief on the view that the regulatory commissions will be able effectively to police discriminatory conduct by BA-NY against its rivals. They also argue that the rivals themselves will be able to detect and deter such conduct. Yet, these are merely suppositions whose validity must be first fully demonstrated. The evidence thus far indicates that the RBOCs have a good deal of leeway in manipulating the conditions needed for competitive supply in local exchange markets, and that the RBOCs have powerful incentives to use their leeway anticompetitively.

25. The public interest assessment of preconditions for in-region, interLATA relief should also consider the current state of competition in the provision of long-distance service. If, hypothetically, current competition in long-distance were ineffective, then the potential risks from RBOC entry would necessarily be weighed against the potential benefits from enhanced competition in the provision of these services. In this context, public interest assessment would have to consider: (i) how ineffective competition were; and (ii) whether or not RBOCs are especially pro-competitive entrants into the provision of long distance services. We show in this affidavit that the long distance market is effectively competitive and that BA-NY's affiliates would not be superior entrants into that market.

B. BA-NY's Public Interest Arguments

26. BA-NY's economists do not offer a coherent methodology for the public interest assessment of preconditions for granting interLATA relief. They agree with us that public interest analysis requires balancing the benefits against the competitive harms arising from BA-NY's proposed entry, but do not spell out how this balance should be struck. Our main disagreement lies in the assessment of the indicia that would enable the fact-finder to determine whether the public interest favors entry or not.

27. BA-NY's economists' arguments in favor of granting relief can be reduced to four basic propositions:

- a. There is already substantial local competition in New York.
- b. Even in the absence of current competition in local exchange markets, regulatory safeguards significantly constrain BA-NY's ability to exercise market power in the provision of local exchange services and make it impossible and unprofitable to lever market power from local exchange to long-distance markets. Moreover, they assert that the requirement that BA-NY offer its long-distance services through a subsidiary further reduces its ability and incentive to engage in anticompetitive conduct.
- c. The long-distance market is behaving non-competitively, so that there are substantial consumer benefits from BA-NY's entry into the provision of in-region, interLATA telecommunications services.
- d. BA-NY will be a particularly potent competitive force in long-distance markets, because it will have low incremental costs of long-distance service, will

benefit from pervasive economies of scale and scope, and will be able to exploit its current marketing position to compete effectively for some customers.

C. Main Conclusions

28. Many of the arguments made by BA-NY's economists in favor of allowing RBOC entry into the provision of in-region interLATA have been made before. In this affidavit, we consider them in the context of the current state of competition in New York. Our general conclusions are as follows:

a. BA-NY's economists have not demonstrated that granting BA-NY's application will be in the public interest, as mandated by subsection 271(d)(3)(C) of TA 96. We conclude that granting the application at this time would not be in the public interest.

b. BA-NY's economists have not demonstrated that there is any effective competition in the provision of local exchange services (including exchange access) in BA-NY's service areas. In fact, as of today, BA-NY faces little competition in the provision of the relevant local exchange services to an overwhelming majority of its customers. The premature authorization of BA-NY's in-region interLATA entry would significantly reduce or eliminate any incentive BA-NY currently may have under Section 271 to cooperate in the development of competition in local exchange markets.

c. BA-NY's economists have not demonstrated that BA-NY is presently providing all of the competitive checklist items of section 271(c)(2)(B) in a "nondiscriminatory" manner, as required by TA 96. Whether the checklist items are provided in such a manner can only be ascertained through the operation of the relevant

market. Such evidence is not yet forthcoming because experience with local exchange competition in the territory of BA-NY is severely limited.

d. BA-NY's economists have not demonstrated that regulatory safeguards will be effective in preventing BA-NY from discriminating against its rivals in local exchange markets. In fact, the necessary regulatory safeguards have not yet been fully developed and their efficacy in ensuring non-discriminatory treatment of BA-NY's competitors has yet to be adequately tested. At the same time, there is persuasive evidence that BA-NY, like other RBOCs, has effectively tried to use the regulatory arena to stymie the development of meaningful competition in the provision of telecommunications services that could compete with its offerings.

e. BA-NY's economists have not demonstrated that long distance markets do not function competitively and that BA-NY's entry is required to generate significant procompetitive benefits to long-distance telecommunications customers. In fact, the methodology used by BA-NY's experts to assess the degree of competition in the long distance market is seriously flawed. Contrary to the assertions of BA-NY's economists, vigorous and flourishing competition today exists in long-distance services.

III. BA-NY CONTINUES TO HAVE MARKET POWER IN NEW YORK LOCAL EXCHANGE AND ACCESS MARKETS

29. At the heart of Dr. Taylor's argument that BA-NY should be allowed into the provision of long distance telecommunications services is the contention that BA-NY does not have market power in the provision of local telecommunications services. As such, it allegedly lacks the ability and the incentive to lessen competition in the provision of long

distance services. We agree with Dr. Taylor that a firm without market power cannot engage in anticompetitive leveraging of market power. We part company with Dr. Taylor in his assessment of market power still held by BA-NY in the provision of local exchange services. In our view, despite some progress that has been made in opening local exchange to competition, BA-NY continues to have incentive and ability to disadvantage its potential long distance rivals who must rely on BA-NY to provide local exchange services (including access). As we shall explain shortly, this incentive stems in part from the fact that price regulation has constrained BA-NY's prices for the provision of local exchange services, including access. Thus, unlike a "plain vanilla" monopolist operating in unregulated markets, BA-NY is forced to charge below-profit maximizing prices for the services it controls. This creates potent incentives for BA-NY to exploit its latent market power in local exchange services in "adjacent," non-coincident markets.

30. A traditional measure of market power used in antitrust and regulatory policy is provided by firm's market share. This is a reasonable place to start, given that a firm with a large market share has a greater incentive to raise price(s) above the competitive level as compared to a firm with a smaller share of the relevant market. Indeed, the larger the share the larger is the base of output on which a firm enjoys an elevation of price above the pertinent measure of cost relative to losses in sales (hence revenue) from such an increase. On this score alone, BA-NY would likely flunk the market power test. As shown below, and detailed in the Affidavit of A. Daniel Kelley filed herewith, BA-NY continues to control an overwhelming share of local access lines. Competitors of BA-NY, whether facilities-based,

UNE-based, or resellers, have made only insignificant inroads into the provision of local exchanges services, especially to residential customers.

31. Competitors have built local facilities only in Manhattan and in a few other urban locations in the state. Kelley Aff. ¶ 2. For all but a small number of New York residential consumers and businesses, BA-NY facilities must be used by competitors to provide local telephone service. Table 1 summarizes the key market penetration data for competitors providing services over their own facilities. Statewide, less than five percent of the local loops are provided by BA-NY's competitors. Id. The share of facilities loops provided by competitors outside of the New York City/Long Island area is only 1.8 percent. Id. The share in the New York City/Long Island area is only 5.7 percent. The share of facilities loops provided by competitors to residential consumers outside the New York City/Long Island area is a minuscule 0.42 percent.

**Table 1 (Source: Kelley Aff. ¶2)
CLEC Facilities-Based Market Penetration**

	Bus.	Res.	Total
Upstate MSAs	5.62%	0.42%	1.82%
Downstate MSAs	10.14%	2.54%	5.70%
All MSAs	9.28%	1.88%	4.75%

32. As summarized in Table 2, the use by competitors of unbundled loops, platform and resale is also limited. Only about four percent of the access lines in BA-NY's service territories are being provided via resale or UNEs. Moreover, resale provides the weakest constraint on BA-NY, because a reseller has less pricing freedom than a facilities or UNE-based CLEC, and is not entitled to access revenues from the resold line.

Table 2 (Source: Kelley Aff. ¶3)
CLEC Non-Facilities-Based Market Penetration

	UNE Bus.	UNE Res.	Resale Bus.	Resale Res.	Total
Upstate MSAs	0.96%	0.82%	10.18%	0.43%	4.12%
Downstate MSAs	1.10%	2.37%	4.44%	0.99%	4.22%
All MSAs	1.07%	1.93%	5.58%	0.83%	4.20%

33. However, as we have stated previously on many occasions, market share by itself is not a sufficient gauge of market power. In fact, even a firm with a large market share can lack market power if expansion by rivals and entry are easy and quick. This seems to be the implicit argument that underlies Dr. Taylor's conclusions regarding the extent of market power that BA-NY still enjoys and is likely to command in the near future. Dr. Taylor recites the large number of CLECs who have entered New York and points to their dramatic growth in gaining market share as evidence that New York has been "irreversibly" opened to competition. Of course, these rates of growth signify very little, given the CLECs' negligible starting point. After all, a firm that increases its penetration from 1000 access lines to 3000 access lines in one year realizes a 300 percent growth rate but remains a competitive "drop in the bucket" in the New York market.

34. More importantly, unlike in other industries, here the entrants must continue to rely on BA-NY -- the dominant incumbent -- to cooperate with them on many fronts. This is plainly true for UNE-based entrants and resellers who must purchase key inputs from the dominant firm in order to compete. Facilities-based entrants also require cooperation from the incumbent such as ensuring smooth switching of customers' loops and efficient interconnection. Consequently, while CLECs are not at the total mercy of the incumbent, they are not independent of it. And, as shown below and especially in the

affidavits being filed herewith by personnel actively involved in AT&T's efforts to provide local service in New York,⁴ BA-NY has maintained significant ability and incentive to impede the progress of competition in New York. Thus, while there is evidence of growing competitive activity in New York, as measured by entry and expansion of CLECs, this activity has not yet undermined BA-NY's latent market power, as we shall show below. Moreover, as reflected in the Kelley Affidavit, while it is the case that some business customers in a few urban areas have available competitive offerings, most business customers and nearly all residential customers continue to have very little choice in terms of alternative providers of local exchange services.

35. The most appropriate index of the extent to which competition has -- or has not -- constrained BA-NY latent market power is the size of the gap between the allowable price caps on local exchange services and the actual prices that BA-NY charges to residential and business customers. As noted before, historically, regulation constrained BA-NY's ability to exercise its monopoly power in the provision of local exchange services, including access. BA-NY's market power has been "latent" in the sense that, if BA-NY were to be freed from the regulatory constraints, it would have elevated its prices to supracompetitive levels. A firm with "latent" market power is compelled to seek its monopoly returns elsewhere. In particular, a regulated firm with latent market power will -- if allowed to do so -- seek to capture some of these unrealized returns in "adjacent,"

⁴ See Affidavits of Robert Aquilina, Edward Mulligan, Raymond Crafton/Timothy M. Connolly, Jack Meek, Robert L. Callahan/Timothy M. Connolly and Dean A. Gropper.

unregulated markets. This is why, historically, regulators have been wary of allowing a regulated monopoly firm to enter unregulated markets.

36. Thus, to gauge the extent to which all of this competitive activity has eroded BA-NY's latent market power, we must compare the actual prices with the price caps. This comparison is reflected in Attachment 4. Attachment 4 indicates that, despite the spate of entry detailed by Dr. Taylor, Bell Atlantic, across all of the states in its service region, maintains its prices at the allowable caps. This evidence further supports the conclusion that entry has not yet been an effective constraint.⁵

37. However, we need to address one possible objection to this analysis. In particular, BA-NY may argue that the allowable price caps on some of its local exchange services are below "competitive" levels, *i.e.*, "below cost." In such a case, it would be unreasonable to assume that entry would erode these prices even further. It is true that competitors are not likely to enter below-cost services and, thus, prices in such services are not likely to be eroded further. But if BA-NY is compelled to provide many such services then its incentive to leverage its latent market power is only enhanced and the ability and incentive of CLECs to constrain its latent market power is only lessened. We have no reason to believe that BA-NY's allowable rates are below costs on average. This is surely not the case with local exchange access, which continues to be priced above any reasonable measure of cost (but likely below monopoly level). Thus we are permitted to conclude that if BA-

⁵ The presence of a "headroom" between the price caps and actual prices is not a sufficient statistic for gauging the extent of latent market power. Competition is only one of various factors why such spread may exist.

NY's rates are not below caps (on average) then it enjoys latent market power. This latent market power gives BA-NY an incentive to exclude rivals from the local market and leverage its market power into adjacent, unregulated telecommunications markets.

IV. AN RBOC'S ENTRY INTO LONG DISTANCE WILL ADVERSELY AFFECT COMPETITION IF THE RBOC MAINTAINS MARKET POWER OVER LOCAL EXCHANGE AND ACCESS SERVICES

38. RBOC provision of in-region interLATA services prior to the development of effective and sustainable local exchange competition creates potential dangers to telecommunications consumers. First, premature entry creates incentives for an RBOC to use its market power in local exchange services to harm competition in the long distance market. Second, premature entry significantly diminishes any RBOC incentives under Section 271 to cooperate in the development of local competition. In the absence of such incentives, there are numerous opportunities for an RBOC to stymie local competition. Third, premature entry can create incentives for an RBOC to misallocate costs from competitive long distance services to local services.

39. When assessing these competitive risks, it is important to realize that anticompetitive misconduct is frequently very difficult to distinguish from colorably legitimate business activities. First, an RBOC can discriminate against its long-distance and local rivals both through action and inaction. Inaction is particularly difficult to detect and deter because it often involves no affirmative wrong-doing. Second, an RBOC can engage in ostensibly "non-discriminatory," legal activities that in fact discriminate against its rivals. Examples are provided below.