

40. The RBOCs' record of documented abuses since the MFJ is consistent with the strategy of disguising misconduct as colorably legitimate business practice. Recent patterns of abuse in local services and adjacent markets are particularly alarming. RBOC rationalizations of various events do little more than document an ability to find and exploit grey areas in the law, and a proclivity to defend all of their actions as being both legal and "in good faith."

A. Leveraging of Local Market Power into the Long Distance Market

1. Incentives to Discriminate

41. RBOC provision of long distance services would create powerful incentives to lever local market power into the long distance market. These incentives arise most directly because binding price regulation significantly constrains RBOCs' ability to exercise market power in local markets. Since the RBOC cannot fully exploit its local market power by setting prices at full monopoly levels, it has an incentive to lever its market power and garner some of those profits in the long-distance market, or any other markets in which it is able to operate without a regulatory restraint on its prices.⁶ By imposing costs on other IXCs, the RBOC can weaken rivals' ability to compete and force them to charge higher prices to cover elevated costs. This creates a profit opportunity for an RBOC. The RBOC can also

⁶ See Affidavit of Marius Schwartz, ¶ 115 submitted on behalf of U.S. Department of Justice, in the Matter of Application of SBC Communications Inc., et al. Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in the State of Michigan, FCC CC Docket No. 97-121 (May 16, 1997) ("Schwartz Aff.") ("[I]ncentives for leverage stem in large part from asymmetric regulation: the firm's prices for bottleneck services are regulated, but its prices for other services that rely on the bottleneck services are not regulated (or less tightly regulated).")

gain artificial advantage and create a profit opportunity by degrading the quality of service provided by other IXCs. The RBOC can then charge a premium price for its services and achieve sales at the expense of other IXCs. The RBOC's market success would arise neither because of greater efficiency nor better meeting consumers' demands, but rather because of anticompetitive conduct that imposes socially unnecessary and harmful costs on its rivals and their customers.

42. Some economists have argued that RBOCs have no incentive to impose costs on other IXCs because doing so would reduce demand for local access, causing the RBOC to lose access revenues.⁷ This argument best applies to an unconstrained monopolist who can set access price at the profit-maximizing level. When contemplating an increase in the price of its offerings, a monopolist always balances greater revenue-per-unit against lower volume. An unconstrained monopolist raises prices to the point where the costs and benefits of further increases in price just offset each other. This remains true even when the unconstrained monopolist sells to a downstream rival, inclusive of impacts on the demand for the monopolist's own downstream offerings. Just as the unconstrained monopolist has no incentive to raise downstream rivals' costs directly by increasing price beyond the monopoly level (due to the resulting reduction in volume), it may also have no incentive to raise rivals'

⁷ See Sibley and Weisman, "Competitive Incentives of Vertically Integrated Local Exchange Carriers," working paper, 1996. Other economists have shown that the models and assumptions employed by Professors Sibley and Weisman are seriously flawed. See T. Randolph Beard, David L. Kaserman, and John W. Mayo, "Regulation, Vertical Integration and Sabotage," working paper, March 1999; and Nicholas Economides, "The Incentive for Non-Price Discrimination by an Input Monopolist," 16 *Int'l J. Indus. Org.* 271 (1998).

costs indirectly through discriminatory practices (due to the same resulting reduction in volume).

43. This logic does not apply to the RBOCs. The RBOCs are constrained by price caps that prevent them from charging the full profit-maximizing monopoly price for access. As a consequence, an RBOC's profits would necessarily increase if it could raise access prices, even though demand for access would fall as a result.⁸ Discrimination against downstream rivals can be thought of as a way to circumvent binding price regulation. Given binding price caps, by degrading service quality and/or imposing costs on its rivals an RBOC is able implicitly to raise access price and capture some of the profits from access in the long-distance market. This simple economics of leveraging -- and in particular the importance of binding price regulation -- seems to have escaped BA-NY's economists' attention.

44. Dr. Taylor argues that emerging local competition substantially reduces the RBOCs' incentives to discriminate against competing IXCs.⁹ IXCs certainly have more access alternatives today than at the time of the MFJ, and still more are likely to emerge over time. However, the impact of nascent access competition has been greatly exaggerated. As discussed above, regulation continues to impose binding constraints on access prices, even at enormous margins over cost. The RBOCs' economists cannot seriously dispute the notion that access prices would be considerably higher if all regulatory restrictions on its pricing

⁸ The revenue effects from a price increase are muted by the fact that the discriminatory strategy diverts traffic to the RBOC from its rivals in the long distance market.

⁹ See Taylor Dec. ¶¶ 60-70.

were removed. Yet, once this proposition is conceded, it follows immediately that emerging local competition has not removed the incentives for abuse. If local competition does not suffice to deter an RBOC from raising access prices above current (or future) regulated levels, then it cannot suffice to deter an RBOC from exploiting the very same latent market power by leveraging it into long distance services.

2. Opportunities to Discriminate

45. RBOCs not only have incentives but also have substantial opportunities to discriminate against long distance competitors who must rely on the incumbents' local networks for originating and terminating access. Likely patterns of RBOC misconduct can be grouped into five broad categories: network design, service availability, pricing, ancillary services, and IXC relations. Examples follow.

a. Network Design

46. The MFJ's line-of-business restrictions fostered a cooperative atmosphere between the RBOCs and the IXCs, since improvements in long distance stimulated demand for access and increased RBOC access fee revenues, which is also why examples illustrating the efficacy of regulation are not apposite to the new environment. In the absence of the interLATA ban, the RBOCs would have strong incentives to become less cooperative with IXCs, and to favor their long distance affiliates on a variety of network design matters. Many opportunities for such behavior are, and will be, present.

47. First, an RBOC could refuse to tailor its offerings to suit competing IXCs. For example, AT&T's *True Voice* technology improved sound quality when used with

high quality access circuits.¹⁰ However, when access circuits were sufficiently noisy, *True Voice* actually made sound quality worse than ordinary long distance service. Thus, by allowing circuit noise to rise generally (not just for AT&T), an RBOC could selectively degrade AT&T's relative service quality. Such a policy could be defended as "non-discriminatory" on the grounds that the RBOC was providing all IXCs with similar quality circuits, but in fact, the impact on AT&T would be more severe.

48. This reflects a general principle: by controlling which non-discriminatory practices are in effect, the RBOC can discriminate against its IXC competitors. In such a case, it would be virtually impossible to establish misconduct, since refusals to tailor existing offerings do occur in the normal course of business.

49. Second, an RBOC could change service offerings to accentuate incompatibilities with IXC services. For example, in June 1994 AT&T submitted a request for service to BellSouth with the intent of establishing a new 500 service. BellSouth indicated an intention to implement the service with a new, untested platform instead of through standard routing, thus forcing AT&T to accept an undesirable architecture and delay implementation until 1995. Since service offerings change in the normal course of business, and since identical offerings would be made to all IXCs, misconduct would again be very difficult to prove.

50. Third, an RBOC could withdraw network capabilities used more effectively by IXCs than by its own affiliate. The RBOCs have already demonstrated a

¹⁰ We rely on the review of internal AT&T documents for this assessment.

proclivity to seek competitive advantage by manipulating the withdrawal of services. Under TA 96, the RBOCs are required to let rivals resell their services, including Centrex. In response to this requirement, US West asked regulators in all 14 of its states for permission to halt new Centrex offerings. Such an action would advantage US West by allowing the company to retain its existing Centrex customers while simultaneously precluding new resale competition using Centrex services. In the words of Jerry Patrick, US West Vice President, "withdrawing a service so nobody else can sell it is competitive."¹¹

51. Fourth, an RBOC could refuse to cooperate with IXCs in the process of innovation, forcing IXCs to design around current local network capabilities and limiting opportunities for testing new services. In contrast, the RBOC's long distance affiliate would benefit from integrated development, experimentation, and product testing.

52. Fifth, an RBOC could selectively introduce network features and capabilities that complement its long distance affiliate, rather than the capabilities of its competitors. It could deploy new capabilities when it had a jump on the development of services, and delay the deployment of capabilities in cases where its own service development efforts lagged behind those of competitors. For example, Bell Atlantic made ISDN BRI capabilities available to Centrex users roughly 15 months before creating similar capabilities for PBX users.¹² As another example, an RBOC might select a different sound-enhancement

¹¹ Leslie Cauley, "Telecom Concerns Love Rivalry Fostered by New Law," *The Wall Street Journal*, March 25, 1996, p. B1.

¹² See Affidavit of Dean A. Gropper filed herewith.

technology than its long distance rivals, and then add features to the rest of its network that function better with its chosen technology than with the alternatives.

53. Finally, an RBOC could make its new network capabilities technically inaccessible to its competitors. To illustrate, suppose a new service combining local and long distance functions can be developed with either a tightly integrated or more modular technology. By choosing to develop the more integrated technology, the RBOC can later claim that the nature of the technology makes functionally equivalent interconnection by its competitors very difficult and costly. Under these circumstances, misconduct would be difficult to prove.

b. Service Availability

54. The substantial control that local carriers have over service provisioning and reliability creates the potential for various forms of abuse. An RBOC could delay the provisioning of requested services by insisting on longer provisioning intervals, failing to process requests in a timely fashion, or by procrastinating in providing information to IXCs. It could increase the likelihood of service blockages by manipulating traffic control and network overload programs. It could provision rivals' services on facilities known to have recurring maintenance problems, shirk on preventative maintenance for such facilities, delay trouble reports, or favor its affiliate in restoring or maintaining service.

55. It is important to realize that many of these discriminatory strategies do not require the RBOC to segregate its long distance affiliate's traffic from that of other IXCs. As described above, successful discrimination only requires that the action *differentially* affect

rivals. Below, we provide examples of “non-discriminatory” service availability problems that have differential effects.

56. When traffic is actually segregated, discrimination against rival IXC's is even more effective. Today, AT&T's incoming calls are often carried over dedicated trunks even for switched access. In addition, interLATA entry would provide the RBOCs with new incentives to segregate their own traffic artificially. An RBOC could divert its traffic to dedicated trunks, or bypass some other portion of the local network, perhaps under the guise of applying a proprietary “enhancement” technology for its long distance customers.

57. Abuse of control over provisioning and reliability would be very difficult to prove. An RBOC could artificially increase system-wide provisioning intervals (including intervals for its own affiliate) whenever a competitor's order volume is high, thereby achieving a differential effect with a “non-discriminatory” policy. This would serve the dual purpose of damaging competitors at the most critical points in time (*e.g.* coinciding with a competitor's intensified advertising campaign), while providing a built-in justification (difficulty handling high order flow). Even if an RBOC selectively increased provisioning intervals for a particular competitor, it could defend systematic differences in provisioning by blaming the competitor for failing to provide timely or accurate information required for provisioning. A slow repair could be attributed to the complexity of the problem, the simultaneous occurrence of multiple problems, or a shortage of trained personnel. Network overloads could be cited (truthfully) as the cause of service blockage.

58. Evidence about the willingness of the RBOCs to engage in abuse of service provisioning is available from the local service arena. Many new CLECs have complained about service outages and interconnection difficulties.¹³ Although an incumbent LEC can claim that the service problems also affected its own local service, it is the timing of service problems is often critical for the nascent competitor. The RBOCs have also manipulated service provisioning regulations intended to benefit consumers. BA-NY's illustrates manipulation of "PIC freezes"¹⁴ illustrates this point. Although PIC freezes are intended to protect consumers from unauthorized switching of long distance carriers, MCI Sprint, AT&T and other carriers introduced evidence that the tactic was used by BA-NY to lock in captive customers who might otherwise switch long distance and local toll carriers.¹⁵

59. BA-NY argues that service degradation would be unlikely to escape the notice of the IXCs or the state and federal regulators. This rosy view of regulation is inconsistent with the historical record, and fails to recognize that many of the discriminatory strategies available to the RBOCs are very difficult to distinguish from the normal course of

¹³ Examples of discrimination against CLECs are provided in the Callahan/Connolly, Crafton/Connolly, Meek and Gropper Affidavits filed along with this Affidavit.

¹⁴ PIC stands for "Primary Interexchange Carrier" and refers to the long distance carrier presubscribed by a customer. A "PIC freeze" occurs when a LEC imposes limitations on customer changes in interexchange carrier; such as a policy precluding such changes unless a subscriber first goes to the effort of providing written authorization directly to the LEC.

¹⁵ *See, e.g.,* NYPSC Case No. 95-C-0650, Joint Complaint of MCI Telecommunications Corp., AT&T Communications of New York, Inc., Sprint Communications Company, L.P. and the Empire Association of Long Distance Telephone Companies, pursuant to Section 912 of the Public Service Law, Against New York Telephone Company Presubscription in NYNEX Service Territories in New York State.

business, making misconduct very difficult to prove.¹⁶ As we have emphasized, unless regulators relieve the RBOCs of all normal business discretion, opportunities for lawful discrimination will remain (*e.g.*, failures to affirmatively promote cooperative service development with IXCs).

60. It has also been suggested that some types of service discrimination would not be implemented because RBOCs could not degrade competitors' service quality without harming their own. This argument fails to recognize the important point that, by controlling which non-discriminatory practices are in effect (and when), an RBOC can differentially affect its IXC competitors.

c. Pricing

61. Current price cap regulations prevent the RBOCs from further exploiting market power by raising access prices across the board. An RBOC can, however, raise some access prices while decreasing others. This creates the incentive to raise prices charged to competing IXCs, while lowering prices charged to its long distance affiliate. Although an RBOC cannot negotiate access charges on a carrier-by-carrier basis, this favoring of an RBOC's long distance affiliate could be accomplished by a variety of apparently "non-discriminatory" discount plans. For example, an RBOC could base discounts on traffic growth rates, distance-to-POP, long term commitments, or other sets of conditions that their affiliates are more likely to satisfy. RBOCs have actually proposed and implemented discounts along these lines. Term pricing plans and charges for channel mileage are already

¹⁶ See Affidavit of Dean A. Gropper.

common. NYNEX proposed a growth-based access discount in Vermont.¹⁷ Pacific Bell developed an optional pricing plan for switched access services targeted at IXC's willing to commit 50 percent of their applicable minutes.¹⁸ Although the IXC's have the opportunity to challenge tariffs that they regard as discriminatory, an RBOC can gain competitive advantage from regulatory delays.

62. Moreover, by charging IXC's prices for access that exceed an RBOC's actual cost of providing access to its affiliate (TSLRIC), an RBOC can provide a cost advantage to its long distance services wholly unrelated to any greater efficiency on the part of the RBOC. Telecommunications carriers will soon begin offering bundles of services that include local exchange and long distance services. The preference of many consumers for "one-stop" shopping will give substantial market advantage to those carriers that can provide this basket of services less expensively. If capped exchange access prices are not based on TSLRIC, the RBOC's can use the cost differential between what their rivals pay them for these elements and the lower economic cost that they incur as a vertically integrated company to gain an artificial advantage in the provision of bundled services. In this way, the RBOC's can weaken their rivals in the supply of bundled, interexchange, and local services, build their own market power, sustain uncompetitive end-user prices, and disappoint hopes for an

¹⁷ In the Matter of NYNEX Telephone Companies' Petition for Waiver of Part 69 of the Commission's Rules to Offer the Vermont Market Plan, FCC Docket No. DA-93-1005, August 18, 1993.

¹⁸ In the Matter of Pacific Bell, Petition for Waiver of Pacific Bell, FCC Docket No. DA 93-1580, December 23, 1993.

efficiently competitive marketplace. Both the incentives and the opportunities for such anticompetitive conduct would be prevalent to an unfortunately high degree in today's telecommunications markets, were the RBOCs permitted to offer interLATA services in-region.

d. Ancillary Services

63. In addition to access, local carriers also provide IXCs with a variety of ancillary services such as billing and on-line transfers to IXC operators. A local carrier could potentially weaken its long distance competitors by withholding these services, providing substandard services, or changing the terms under which they are offered.

64. For example, when SNET began selling long distance services in Connecticut it terminated its longtime practice of rendering bills for AT&T, forcing the IXC to bill customers separately. Although AT&T had announced plans to terminate its billing relationship with SNET in the future, the apparent explanation for SNET's decision to terminate billing *immediately* was that SNET's increased long-distance profits resulting from discrimination against AT&T would more than offset profits lost from the termination of SNET's cooperative billing arrangement. Similarly, SNET has terminated its practice of making on-line transfers to long distance service representatives, thereby making it less convenient for customers to switch providers and to obtain customer service.

65. A local carrier could also provide its long distance affiliate with informal ancillary services not available to competing IXCs. In the ordinary course of business, local carriers acquire extensive information about individual IXCs. For example,

when an IXC seeks new access arrangements it provides the local carrier with confidential information about service offerings, customer characteristics, projected demand and technology. A local carrier would have a strong incentive to share this privileged information with its long distance affiliate. The provisions of Section 272 prohibiting the transfer of privileged information will not likely prevent its misuse by the local carrier in view of its incentives in today's marketplace. Even if the RBOC does not share with its affiliate information about a competing IXC's new service offering, it will still be aware that a competitor has developed a new service that its affiliate has not yet developed. It can misuse this knowledge by choosing to delay provision of the necessary access until its affiliate has developed a similar service.

e. IXC Relations

66. The interaction between RBOCs and IXCs is a complex and, at present, a cooperative process. Both the RBOCs and the IXCs must devote considerable resources to make this process work. The RBOCs currently employ a small army of individuals whose sole functions concern IXC relations. RBOCs willingly expend these resources because it is in their economic interests to make sure the IXCs are reasonably well-served. Once the RBOCs are permitted to enter in-region interLATA service, they will have every incentive to make sure that these complex cooperative arrangements become less efficient and effective, and this is mostly easily accomplished through inaction. The RBOCs may do irreparable damage to the IXCs simply by failing to fund and staff IXC relations adequately.

B. Harm to Local Competition

67. The RBOCs and other LECs also have substantial incentives to discriminate against new entrants into local exchange markets. TA 96 requires unbundling and resale of local exchange service components, in part to reduce opportunities for abuse by opening up what has been, until now, an impenetrable “black box.” However, in practice it is difficult to know whether the provisions of the TA 96 will have any impact on the RBOCs’ ability to discriminate against competitors, and there is considerable risk they may not. Moreover, an RBOC’s incentive to cooperate in the development of local competition is currently much greater than it would be absent the interLATA ban. At present RBOC misconduct is disciplined both by the “carrot” of interLATA relief and the “stick” of regulation and antitrust enforcement. After being allowed to enter the interLATA market, only the stick would remain.¹⁹

68. Concern over the development of local competition arises for a number of reasons. First, the process for setting the terms and conditions of interconnection, unbundling, and resale is proving to be highly contentious. Although TA 96 requires cost-based pricing, incumbent LECs and their would-be rivals differ sharply on the proper measures of pertinent costs. True to form, the RBOCs attacked the pricing rules proposed by the FCC, and the pricing of UNEs remains unsettled.²⁰ The RBOCs have also exploited their

¹⁹ See *Schwartz Aff.* ¶ 157 (“[O]nce entry is authorized, BOC incentives to continue cooperating will diminish significantly”).

²⁰ See *Iowa Utilities Bd. v. FCC*, No. 96-3221 (8th Cir.) (pending on remand).

informational advantages to argue for high “additives,” because of alleged high joint and common costs, and for costing methodologies that potentially artificially elevate the costs on which UNE prices are to be based (*i.e.*, the TELRICs). While these entry-impeding strategies are perfectly rational for the RBOCs to pursue, and may be lawful, they elevate the risks faced by CLECs. In many instances, interconnection negotiations have completely stalled. Frustrated by the LECs’ ability to stonewall, a number of CLECs have sought regulatory intervention.²¹

69. Second, the terms and conditions of interconnection, unbundling, and resale are determined through procedures that are heavily biased in favor of incumbent LECs. Negotiating power is unevenly distributed between the LECs and the aspiring CLECs. To provide switched services in any given area, a CLEC must come to terms with the incumbent LEC. However, under TA 96, the incumbent LEC need not come to terms with every CLEC. Since the CLECs are in competition with each other the LEC is in a position to play one CLEC off against another. The result is a “race to the bottom,” wherein each CLEC is highly motivated to accept less desirable terms so that it can beat its rivals to the market. In addition, regulators look to negotiated agreements for benchmarks, on the grounds that any voluntary arrangement is presumably fair and reasonable. Once benchmarks are established, the consequences of uneven negotiation are institutionalized. This reinforces the LEC’s

²¹ See, *e.g.*, Mark Rockwell, “Bells Open Network to Cable Cos.,” *Communications Week*, no. 614, June 10, 1996, p. 1.

incentives to accommodate small CLECs that are willing to settle for quick entry at unattractive terms.

70. This characterization of negotiating incentives under TA 96 finds considerable support in actual experience. Virtually all the early interconnection agreements were signed with small CLECs, rather than with large IXCs. MFS, cable companies, and others beat the likes of AT&T to the market specifically because they were willing to accept "much looser terms in hopes of breaking into the market right away."²² In their rush to the market, these companies chose to forego "luxuries" such as "full-featured telephone number portability and an accounting system that prevents RBOCs from charging wholesale fees based on past investments in network plant and equipment."²³

71. Third, unbundling will not pare down local networks to irreducible components. For example, a local loop consists of an array of facilities between an RBOC switch and customer interface. As a result, an RBOC would be left with considerable ability to impair services provided over loops "purchased" by competitors. The RBOC could leave a customer without service during conversion to a competitive provider, give priority for repair and reactivation to its own customers, reduce quality for competitors' customers by selectively misaligning loops, or fail to provide adequate preventative maintenance. This is precisely the experience AT&T and other CLECs have endured in attempting to provide local

²² David Rhode, "AT&T Grips While Rivals Rush to Local Loop," *Network World*, vol. 13, no. 25, June 17, 1996, p. 1.

²³ *Id.*

service in New York. As described in the Affidavit of Jack Meek, BA-NY has for months consistently failed to follow agreed upon procedures for performing loop "hot cuts" on customers moving from BA-NY to AT&T and, as a result, has consistently put out of service over 10 percent of the customers whose service was being switched.

72. Local loops are also particularly vulnerable to discriminatory strategies involving the manipulation of network design. Even now, some loops are harder to unbundle than others. The most technologically advanced loops ("integrated digital loop carrier," or IDLC) carry digital signals all the way to the switch. There are only two ways currently to unbundle such loops, neither of which is satisfactory.²⁴ The RBOCs refused to consider unbundling these loops at all until the FCC ruled that such unbundling was "technically feasible."²⁵

73. A striking example of this phenomenon is BA-NY's significant delays in providing unbundled xDSL loops to CLECs seeking to offer advanced telecommunications services.²⁶ BA-NY provides these services to its own customers, but it has taken every opportunity to slow its competitors' ability to deliver these advanced services.

²⁴ If older plant happens to be available out in the field, the CLEC can be given that technology. Equipment can also be installed in the central office which converts signals back to analog, so that they can be transferred to the CLEC in the traditional manner.

²⁵ First Report and Order, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 ¶ 384, CC Docket No. 95-185 (rel. Aug. 8, 1996).

²⁶ See Affidavit of Dean A. Gropper.

74. Opportunities for discrimination also exist in the provision of other local network components. Transport is subject to the full range of discriminatory practices discussed above. Discrimination at the switch is somewhat more difficult, since it would usually require software modifications that would be detectable through audits, and might be difficult to pass off as emanating from legitimate business objectives. However, only experience will establish whether meaningful unbundling of switching is possible to achieve in practice.

75. As noted above, RBOC misconduct is currently disciplined by the “carrot” of interLATA relief and the “stick” of regulation. When weighing whether to remove the “carrot” by allowing RBOC entry into in-region interLATA services, it must be acknowledged that even the carrot and stick together have often been insufficient to deter abuses by RBOCs, including BA-NY, and other incumbent LECs. The examples contained in the affidavits of AT&T personnel involved in the company's attempt to enter New York local markets illustrate these types of conduct.²⁷

C. Cost Misallocation

76. In the absence of the interLATA ban, an RBOC would be able to offer long distance services under conditions of little or no regulation while continuing to provide local services subject to regulatory constraints that link prices to costs. This creates the

²⁷ See Affidavits of Robert Aquilina, Edward Mulligan, Robert L. Callahan/Timothy M. Connolly, Raymond Crafton/Timothy M. Connolly, Jack Meek, and Dean A. Gropper.

incentive to misallocate costs from long distance services to local services and thereby circumvent regulation of local services.

77. The incentive to misallocate costs arises when regulated prices are linked to costs. Although the FCC and a sizable majority of states have now abandoned traditional rate of return regulation, all but a handful of states have opted for hybrid forms of “incentive” regulation, rather than genuine pure price caps. Typically, these hybrids require LECs to reduce prices of basic services when profits exceed certain thresholds, and they often allow LECs to raise prices of basic services when profits fall below other thresholds. Under a hybrid regulatory scheme of this type, a LEC may, to some significant extent, benefit from attributing a larger share of costs to regulated services.

78. Even under genuine pure price cap regulatory schemes, some link between prices and costs generally remains. For example, at the time a new service is introduced, there is no price to form a reasonable basis for an initial cap. Typically, regulators set the initial cap by examining costs, creating an incentive for a LEC to shift costs to the new service. In any case, the fact that an RBOC can shift costs (and cost recovery) from long-distance to local services, including UNEs, means that it does not have to drive out rivals from the market in order to *recoup* the costs of its anticompetitive pricing and other conduct.

79. An RBOC might decide to cross-subsidize long distance services for yet another reason. If long distance and local services share joint and common facilities, then the artificial growth of the RBOC’s long distance services may be used to justify the expansion of

these facilities. Some of the incremental joint and common investments associated with this expansion could gainfully be allocated to local services and to unbundled network elements, thus rationalizing an increase (or forestalling a decrease) in rates for local service and unbundled network elements, as well as creating a competitive advantage against rivals who cannot recover costs in regulated markets.

80. Since the MFJ was entered, federal and state regulators have adopted improved accounting safeguards that are intended to prevent cost misallocation and other misconduct. While these developments have probably helped regulators to identify instances of cost misallocation more effectively, existing safeguards do not provide adequate protection against abuse. The complexity and sheer scope of the RBOCs' operations create numerous opportunities for creative accounting, and make it virtually impossible for regulators to monitor activities on a sufficiently minute scale to identify many abuses. Complementarities between various telecommunications activities can render the purpose of expenditures ambiguous, and the allocation of these expenditures is frequently subjective. Accounting systems necessarily have loopholes that can be found and exploited by those with sufficient monetary incentives.²⁸ The ability of regulators to obtain essential information is often limited by the RBOCs' willingness to comply, and the RBOCs can exploit the inherent ambiguities in this process by challenging all unfavorable rulings, necessitating protracted reviews. Given these difficulties, it is not at all surprising that a large number of experienced

²⁸ Various accounting loopholes are described in Economics Technology, Inc. and Hatfield Associates, Inc., "Monopoly Power and the Local Exchange Carriers," 1994, Ch. 6.

regulators and accountants have emphasized the limitations of accounting safeguards.²⁹

Finally, existing accounting safeguards have never been tested in an environment where the RBOCs have full freedom to integrate and diversify despite control over the remaining bottlenecks.

V. PRESENT REGULATORY SAFEGUARDS HAVE NOT BEEN SHOWN TO BE EFFECTIVE IN CONSTRAINING BA-NY'S MARKET POWER

A. The Requisite Regulatory Safeguards Have Not Been Time Tested

81. Supporters of interLATA relief have suggested that the FCC's non-discrimination requirements are not only adequate in theory, but have also been proven effective in practice. Indeed, Dr. Taylor appears to argue that regulation itself will be sufficient to deter anticompetitive behavior.³⁰ If this were true, however, Congress need not have included a public interest test in TA 96. It could have merely conditioned RBOC in-region interLATA entry upon the adoption of appropriate regulations. Instead, recognizing that regulations alone have never been deemed sufficient to check monopolist abuses, Congress has required the Commission to weigh separately the competitive impact of RBOC entry, in light of existing regulations.³¹ Thus, by urging the Commission to rely solely upon

²⁹ See, e.g., Affidavit of C.L. Wilkins/S.R. Braunstein/R.G. Goodlet, attachment 13, Appendix A, Volume III and Affidavit of P.M. Worthy, attachment 14, Appendix A, Volume III of AT&T's Opposition to Four RBOCs' Motion to Vacate Decree, United States v. Western Electric Co., CA No. 82-0192 (HHG) (D.D.C. 1994).

³⁰ Taylor Dec. ¶¶ 71-75.

³¹ See 47 U.S.C. § 271(d)(3)(B).

the putative efficacy of regulations, BA-NY is urging the Commission to abdicate its responsibility under Section 271.

82. Moreover, our reading of the historical record is inconsistent with the assertion that regulations have proven effective in the past. At best, in the post-Decree period, the incentives for RBOC abuses have been confined by line of business restrictions to a narrow set of RBOC markets.

83. Those who attribute a decline in anticompetitive abuses in the post-Decree period to regulatory success fail to consider the impact of changed incentives. In fact, for more than a decade RBOCs had strong incentives to promote equal access (since this raised the demand for local services) rather than impede it. The incentives of the RBOCs change dramatically with the prospect of interLATA relief, and any generalization of regulatory success from the post-Decree period to a new environment with much stronger incentives for anticompetitive conduct would be dangerous indeed.

84. In particular, historically, regulations did not aim to create and safeguard local competition; there simply was no local competition to speak of, with the sole exception of CAPs. Moreover, history shows that even prior to the passage of TA 96, the RBOCs tried to keep the CAPs out through anticompetitive means.³² The new regulations will have to be effective in constraining anticompetitive conduct against new entrants who are squarely aimed at the ILECs' source of market power, which is their monopoly control of the local network. Moreover, these regulatory safeguards will have to protect the IXCs against

³² See examples in Section IV above.

the possibility of anticompetitive leveraging of market power from the local domain to long distance. At present, the necessary ingredients of an effective regulatory regime have not been tested.

85. The RBOCs and their economic experts have, in this and other contexts, alleged that, since the Decree, regulatory safeguards have been tested and have proven effective in a variety of markets that are dependent on local exchange services. They offer a number of examples, including cellular service and intraLATA toll services, among others. In our view, the indisputable evidence of widespread discrimination against local competitors is far more telling.³³

B. Regulation Will Not Eliminate BA-NY's Incentive and Ability to Discriminate Against its Competitors

86. There is every reason to believe that regulators and the courts would *attempt* to meet the challenge created by the RBOCs' re-entry into long distance. However, given the substantial incentives and opportunities for an RBOC to discriminate against its rivals, it is not certain that regulation will meet with more than limited success. The current regulatory structure has not yet been employed to deal with the types of subtle abuses identified in section IV. In this section we assess the capabilities of regulatory oversight to prevent anticompetitive conduct and enforce competitive safeguards.

87. The FCC and the State PUCs can, in principle, simply forbid an RBOC from engaging in certain forms of misconduct. If there are clear and easily codified and

³³ The relevance of experience in intraLATA toll markets is undermined by the prominence of dialing parity issues.

verifiable indicators for the existence of a violation, this proscriptive approach can be effective. However, as described in section IV, most of the potential for RBOC discrimination against competitors arises from colorably legitimate activities that are typically hard to distinguish from ordinary business practices. Regulators must either leave room for ambiguity or run the risk of outlawing legitimate behavior. Even if some forms of misconduct are successfully proscribed, RBOC control of the local bottleneck would allow them to devise new methods of discrimination.

88. Another regulatory approach is to use the threat of punishment to deter misconduct. For the RBOCs any deterrence effect is likely to be very weak.³⁴ Again, the most likely forms of RBOC misconduct are those that can be cloaked in colorably legitimate business practices, making them very difficult to detect, prosecute, and punish. As discussed in section IV, many types of discrimination are not illegal, but fall in the “grey area” of the law. Extensive hearings and detailed reviews of the evidentiary record are required to evaluate allegations of misconduct, and even then outcomes are highly uncertain. Disputes between incumbent LEC’s and potential competitors are resolved through costly and protracted litigation and delay works to the incumbent LEC’s favor.

89. Finally, meaningful local competition cannot emerge without affirmative steps by the LECs. This implies that a LEC can delay and discourage competition

³⁴ BA-NY has proposed an enforcement mechanism consisting of performance standards and penalties which purportedly would deter its anticompetitive conduct if it is permitted to provide long distance service. The shortcomings of BA-NY’s proposal are discussed in the affidavits of Michael Kalb/Michael Pfau and R. Glenn Hubbard/William H. Lehr.

merely by dragging its feet, using tactics that are difficult to verify and regulate. This foot-dragging can take the forms of outright obstruction, slow-moving negotiations, and appeals to regulatory and/or judicial bodies.

90. The existence of regulatory discretion at the state level is likely to further slow the emergence of local competition. While the FCC sets general guidelines, the states have substantial discretion with respect to the details of implementing TA 96. Every decision that places an obstacle in the path of competition will need to be reviewed and overturned by the FCC or the courts. For example, in May 1996, AT&T was compelled to seek federal preemption of a Texas law restricting competitive entry into local services. The Texas law prohibited IXCs with more than 6 percent of the long distance market from reselling local services. In defending this provision, Southwestern Bell argued that federal preemption was not justified under the terms of the TA 96.³⁵ In April 1996, MFS was forced to seek federal preemption of rulemaking proceedings in the District of Columbia, where regulators had delayed MFS's applications to provide private line and switched services for eight years and two years, respectively.³⁶ Even FCC preemption of these and similar actions would not negate the underlying problem. Most obviously, the need to seek federal preemption delays the onset of competition. More importantly, there are likely to be many

³⁵ Comments of Southwestern Bell Telephone Company, July 3, 1996, Docket on Preemption of Texas Law.

³⁶ Petition for Preemption, Declaratory Ruling and Injunctive Relief, Submitted to the FCC, in the Matter of MFS Communications, Inc., April 30, 1996, CCB Pol 96-12.

state decisions that favor the LECs, but that do not clearly step over the line that invites federal preemption.

C. The Separate Affiliate Requirement Does Not Obviate Competitive Concerns

91. Section 272 of TA 96 mandates that a BOC offers its long distance services, including origination of interLATA telecommunications services, through a separate affiliate. BA-NY's economists argue that the separate affiliate requirement adds another safeguard against anticompetitive behavior by BA-NY against its long distance rivals. In fact, the mandated separation between the long distance affiliate and the local operating company diminishes, but does not obviate, the competitive concerns. It does not ensure that BA-NY will have no incentive or ability to engage in conduct that is harmful to competition.

92. First, provision of long distance services through an affiliate will not diminish RBOCs' incentives -- although it may somewhat constrain the ability -- to shift costs from the competitive service (long distance) to a less competitive service (local exchange). Experience from state regulatory and arbitration proceedings relating to the implementation of Section 251 of TA 96 and the pricing of UNEs demonstrates that there is a great deal of leeway in how various elements of costs are allocated between unbundled elements and the retail operations of the LEC. Once an RBOC is allowed into in-region interLATA services, its retail operations would encompass those services as well. The affiliate will be allowed to provide, as well as market, all telecommunications services. Hence, an RBOC will have yet another incentive to shift costs into its more protected activities. For example, an RBOC could shift costs on UNEs by either overstating the TELRICs of the elements or by increasing

the pool of joint and common costs that the RBOC will be allowed to recover by means of additives on the underlying TELRICs. By shifting costs on the UNEs, the RBOC simultaneously advantages its long-distance affiliate and disadvantages potential entrants into the local market.

93. Second, for technological reasons, clean separation between local and long distance telecommunications facilities is impossible to implement. In an earlier affidavit for the RBOCs, Professor Armen Alchian wrote:

In the absence of regulation, this kind of technological change would alter the degree of vertical integration in the industry. Without any clear long distance "gateways" -- central points equivalent to class 3 switches -- long-distance and local service facilities would become integrated throughout the system. With no "toll" lines, and no "toll" switches, long-distance would become a service transported throughout the network with every function potentially involved in every call. There would be nothing to be separately owned or controlled, no clear break point between interexchange and local exchange facilities and service.³⁷

94. We find it difficult to imagine how one would even begin to define equal access and non-discriminatory treatment of unaffiliated IXC's in such a world. It is, indeed, difficult to imagine how much real separation there can be between the local operating company and its long-distance affiliate when the critical assets of both companies are inextricably commingled. Thus, technological change has rendered, and will continue to render, regulation inherently less effective at policing competitive abuses, even in the presence of a nominally separate long-distance affiliate.

³⁷ Affidavit of Armen Alchian, pp. 7-8, attachment 1 of Appendix Volume I, submitted with the Four RBOCs' Motion to Vacate the Decree, United States v. Western Electric Co., (HHG) CA No. 82-0192 (D.D.C. 1994).

95. This brings us to our third point: if the separate affiliate requirement successfully deters abuse, then it is difficult to understand how a separate affiliate could play a special competitive role in the interexchange marketplace, as envisioned by BA-NY's economists. Indeed, why should BA-NY's subsidiary have any different incentives or ability to be a more aggressive competitor as compared to an unaffiliated carrier? Several reasons can be offered and found wanting upon examination. First, the affiliate may be more technologically efficient. However, the likely efficiency advantages should not be substantial if the affiliate's key facilities and other productive assets are effectively separated from that of the local operating company, and if the LEC's services are available to all IXCs on a nondiscriminatory basis. In any case, BA-NY's experts do not offer any real evidence that the separate affiliate will, in fact, enjoy significant, real technological efficiency advantages.

96. Second, the affiliate may benefit from discriminatory treatment from the parent that gives it a competitive advantage over the unaffiliated carriers. To the extent that such discriminatory treatment will raise the costs of the affiliate's rivals, it will not have the postulated procompetitive effect on rates. Instead, it will have the effect of shifting traffic to the affiliate while either raising (or maintaining) the current rates. BA-NY's experts do not acknowledge this possibility, of course. They argue that BA-NY will have no incentive or ability to advantage the affiliate, and even if it could advantage the affiliate, it would not do so.

97. The third reason for why the affiliate may be more competitive than the unaffiliated entrant has to do with the incentives for traffic stimulation. Proponents of RBOC

interLATA entry argue that RBOCs have no incentive to raise rivals' costs because that would constrict interexchange traffic below already repressed levels and reduce access revenues. They do not explain why a supposedly separate interexchange affiliate would experience the claimed incentives to lower prices in order to stimulate interLATA traffic. Indeed, if true, this would be a very curious rationale for granting BA-NY's application. Surely, if the affiliate's costs are the same as those of an equally situated non-affiliated new entrant, its incentives to undercut current rates should not be any different. More importantly, if the affiliate is truly a separate profit center, as required by the TA 96, its choice of business strategies (including pricing) should not be guided by their impact on the profitability of the affiliated local operating company. In particular, the affiliate would have to pay the same access fees as do the unaffiliated carriers. Failing to do so would violate the requirement in paragraph 272(e)(3) that "[a] Bell operating company ... shall charge the affiliate ... or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carrier for such service..." Yet, it is not clear how the affiliate could have significantly lower costs (relative to unaffiliated carriers) unless the implicit price it pays for access is significantly lower.

98. Since BA-NY's experts cannot point to any real efficiency advantages, we conclude that they implicitly acknowledge that the affiliate will receive preferential (i.e., discriminatory) treatment from the local operating company, or that BA-NY will violate the provisions of the separate affiliate safeguard.

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. _____

A. Competitive Conditions in Long Distance

99. At this point in history, there is abundant evidence that the long distance market is vigorously competitive. Although the evidence that has accumulated since the AT&T divestiture is described in detail below, in the last several months alone AT&T, MCI/WorldCom and Sprint have cut rates for residential long-distance charges by as much as 50 percent. All three companies now feature calling plans offering long distance service at just five cents per minute.³⁸ All this evidence has caused this Commission to acknowledge

³⁸ For example, AT&T offers a rate of five cents per minute at all times for a monthly fee of \$9.95. Sprint offers a rate of five cents per minute from 7:00 pm to midnight every day and 10 cents per minute at other times, all for a monthly fee of \$5.95.