REPORT ON

SOME ANTICOMPETITIVE ASPECTS OF THE PROPOSED MERGER OF QWEST AND U S WEST

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1. INTRODUCTION AND QUALIFICATIONS

I, Bridger M. Mitchell, am a vice president of Charles River Associates Incorporated, an economics, finance and business consulting firm with offices in Boston, Massachusetts and six other cities. I am the director of the Palo Alto office, which is located at 285 Hamilton Avenue, Palo Alto, California.

I received an A.B. with a major in economics from Stanford University in 1962 and a Ph.D. in economics from M.I.T. in 1970. I was an assistant professor in the Department of Economics at Stanford University from 1966 to 1971, and have subsequently taught economics courses at Stanford as an acting associate professor and at UCLA as a lecturer in economics. In 1971 and 1972 I was an economics policy fellow at the Brookings Institution and the Department of Health, Education and Welfare. From 1972 to 1994 I was a senior economist at the RAND Corporation in Santa Monica, CA. I am a member of the American Economics Association and the International Telecommunications Society.

My fields of specialization within economics are industrial organization, regulation, and microeconomics. I have co-authored five books and written a large of number of articles published in professional journals and books. In the telecommunications industries I have conducted studies of telecommunications competition, incremental costs of local telephone networks, interconnection of telecommunications networks, demand for telephone services, pricing of telecommunications services, cable television regulation, and the allocation of spectrum resources. I have provided expert consultation and testimony in telecommunications cases, as listed in my curriculum vita.

I have been asked by McLeodUSA to comment on the proposed merger between Qwest Communications International Inc. and U S West, Inc. (CC Docket No. 99-272).

1.1. Definitions

I will refer to the merging parties as "Applicants." I will not distinguish between a company and its wholly owned affiliates (e.g., references to "Qwest" include LCI, UCSD, Phoenix, etc.) The terms "in-region" and "out-of-region" refer to the region of the United States served by U S West. The term "ILEC" refers to both pre-merger U S West and to the ILEC part of post-merger Qwest. Similarly, "Qwest" refers to both pre-merger Qwest and the corresponding part of post-merger Qwest.

1.2. Summary

The merger would increase the ILEC's incentive and ability (1) to circumvent regulation by diverting revenues from its regulated basic phone services divisions to its unregulated advanced services divisions, and (2) to act anticompetitively towards other CLECs and IXCs. Both kinds of actions would degrade the quality of service provided to consumers and other telecommunications carriers.

The Applicants have not provided any convincing argument in support of their efficiency claims. On the contrary, they have admitted that the merger has no rationale unless the merged entity will be granted relief from the interLATA restrictions in Section 271 of the Telecommunications Act of 1996.

I conclude that, unless the Applicants commit to an enforceable set of measures aimed at ensuring the quality of services provided to other carriers and end-users, the merger would not be in the public interest.

2. EFFECTS ON CIRCUMVENTION OF REGULATION

The asymmetry of information between regulators and regulated firms is a fact of life that almost certainly cannot be avoided, and surely not without spending extravagant (and inefficient) amounts of resources. This asymmetry provides the ILEC two main avenues by which it can attempt to circumvent regulatory obstacles to its exploitation of monopoly power. First, the ILEC can try to misinform regulators about its cost structure in order to obtain higher price ceilings or lower quality floors for its regulated services. Second, it can try to misinform regulators about the actual quality of its regulated services and thus save on the expenses and investments necessary to achieve quality levels specified by regulation.

The relative strength of these two strategies (cost misinformation and quality misinformation) will depend on the structure of regulation. For example, the incentives for quality degradation are stronger under price-cap regulation than under rate-of-return regulation.[1] It should be noted, however, that regulation is almost always of a hybrid form[2] and that the ILEC will have incentives to pursue both strategies.

Since total profits can be assessed with some precision from accounting data and market valuations (for example, stock prices) and since these data convey information about the firm's cost structure and expenses, a particularly effective form of misinformation is to divert resources from the regulated to unregulated divisions within the company. The ILEC can accomplish this diversion directly by reducing investments in its regulated division or indirectly by distorting the allocation of common costs. In some cases the ILEC might even have an incentive to adopt inefficient technologies with high common costs over more efficient (but more "transparent") technologies with smaller common costs.

The projects necessary to increase quality of service are likely to suffer the most from reduced investments in the ILEC's regulated division, mainly because the costs and benefits of quality of service investments are hard for regulators to evaluate. In the case of the quality of services provided to CLECs, this problem is particularly severe because regulatory pressure is essentially the only motivation for the ILEC to provide such services.

2.1. Learning from U S West's past

Regulators' experiences with U S West have demonstrated that U S West has not only the incentives but also considerable ability to manipulate the quality of its services. Carriers, such as McLeodUSA and AT&T, that measure the quality of services they purchase from ILECs have found that U S West's performance is inferior to service obtained from out-of-region ILECs.

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[1] For a simple formal model showing that a monopolist subject to price-cap regulation will provide sub-optimal quality levels, see M. Armstrong, S. Cowan and J. Vickers, *Regulatory Reform: Economic Analysis and British Experience*, The MIT Press, Cambridge, MA, 1994, p. 173.

[2] On the one hand, cost-based regulation maintains some flexibility in the choice of costs that are allowed into the rate base and regulated rates are not adjusted instantly, thus acting as short-term price caps. On the other hand, price caps and X-factors under incentive regulation are not set once-and-for-all and information about realized profits is invariably used in their update. See Armstrong et al., cited above, or D. E. M. Sappington and D. L. Weisman, *Designing Incentive Regulation for the Telecommunications Industry*, The MIT Press, Cambridge, MA, 1996 for a more detailed comparison of cost-based and incentive regulation.

As described in the testimony submitted recently to the Colorado Public Service Commission and the Iowa Utilities Board by Mr. Stacey Stewart, Vice President – ILEC Relations of McLeodUSA,[3] U S West has denied McLeodUSA access to necessary facilities and engaged in a variety of behaviors that prevent McLeodUSA from receiving timely wholesale services.

McLeodUSA obtains services from U S West and Ameritech in many of the twenty-one states they serve. Mr. Stewart summarizes monthly performance indicators that McLeodUSA compiles on services provided by those RBOCS. For provisioning of facilities used by McLeodUSA for the resale of Centrex services, the measured performance by U S West has been inferior to the performance of Ameritech. For example, during the first 10 months of 1999, in the case of U S West 47% of all reported out-of-service conditions exceeded 24 hours as compared with 25% for Ameritech-supplied service. The average time required to restore service was 45 hours from U S West, compared with 35 hours needed by Ameritech. And U S West confirmed only 22% of firm orders within 48 hours, as compared with 54% for Ameritech.

AT&T's reported experience with U S West is based on a uniform set of direct measures of quality (DMOQs) for access services that AT&T purchases from the RBOCs. U S West's performance on these measures in 1999 "is last or second to last among all RBOCs for each of the DMOQs." For example, across the U S West region in 1999, U S West's percentage of new DS1 services that were provisioned not later than the customer desired due date was less that 60%, and the percentage for new DS0 services was less than 78%; this compares to the best-in-class RBOC performance of 98%-100%.[4]

The ILEC also has the ability to selectively degrade service quality to other carriers and discriminate in favor of its own services and those of its affiliates. McLeodUSA reports that U S West has attempted to withdraw Centrex service, imposed discriminatory charges for Centrex, database, and other services, and limited changes in Centrex service.[5]

AT&T complains that U S West provides its affiliates, such as its data network affiliate U S West !nterprise, with access to blocking information, network locations where its facilities are at or near

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[3] See Direct Testimony of Stacey Stewart on Behalf of McLeodUSA, Colorado Public Utilities Commission, Docket No. 99A-407T, Dec. 7, 1999 and Iowa Utilities Branch, Docket No. SPU-99-27, Dec. 3, 1999.

[4] AT&T, "Complaint and Request for Expedited Treatment," Colorado Public Utilities Commission, pp. 6-9.

[5] See Stewart's testimony, cited above.

capacity, and which central offices are selected for expansion, but refuses to provide such information to AT&T.[6]

Very substantial deficiencies in the quality of service provided to U S West's retail consumers are apparent in the Commission's recent tabulation of LEC quality of service provided by the seven RBOC holding companies, GTE, and Sprint.[7] In 1998, complaints to federal and state regulators rose to 722 per million U S West residential access lines from the 532 per million lines of the previous year, greatly exceeding the next-highest number of complaints, 245 per million NYNEX residential lines in 1998. In 1998, U S West's business customers also complained at more than three times the rate of the LEC with the next-highest number of complaints. More than one-third of all troubles reported to U S West result in a repeat trouble report, compared with fewer than 21% for the next-highest LEC. And unscheduled U S West switch outages caused an average loss of service of 9.9 minutes per access line during 1998, compared with 3.5 minutes for the next-highest LEC. The relatively low quality of U S West's service does not appear to be due to structural backwardness: "prior to 1993, U S West often performed at or near the top in some DMOQs compared to the other RBOCs." [8] The decline in service quality appears to coincide with U S West's expansion in the market for advanced telecommunication services and this is suggestive of a revenue diversion strategy.[9]

The unsatisfactory quality of U S West's service has been acknowledged by the company's CEO who stated that "A portion of our customers aren't getting the level of service they expect to receive." The company set year-end 1999 goals to make a 30% improvement in the number of held orders and to repair 65% of out-of-service trouble reports within 24 hours. Spending for

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[6] AT&T, "Complaint and Request for Expedited Treatment," Colorado Public Utilities Commission, p. 14.

[7] J. Kraushaar, "Quality of Service of the Local Operating Companies Aggregated to the Holding Company Level, 1996 – 1998", FCC, Industry Analysis Division, Common Carrier Bureau, released December 1, 1999. Statistics in the text are from Tables 2(a) and 3(a).

[8] AT&T, "Complaint and Request for Expedited Treatment," Colorado Public Utilities Commission, p. 8. According to an article by Stuart Steers, "In 1992, the [Colorado] PUC logged 2,500 complaints against the company [U S West]; last year they numbered more than 6,000. (Most of the other states in U S West's territory — which extends from Oregon to Iowa — reported similar experiences.)" See "Liars on the Line," *Denver westword.com*, November 11-17, 1999, available at http://www.westword.com/issues/1999-11-11/feature.html).

[9] The article by Stuart Steers mentioned in the previous footnote also provides information on lawsuits that have been filed against U S West precisely for allegedly diverting money from necessary network investments to other lines of business.

service improvements in 1999 has been announced to increase by more than $1 billion more than was spent in 1998.[10]

State regulators have also faced considerable difficulties in *enforcing* regulatory policies when U S West operates unregulated affiliates and can transfer assets between regulated and unregulated activities. As an example, consider the experience with directory publishing operations. Prior to 1984, U S West's directory publishing operations were provided on an integrated basis with its local exchange services and the revenues from its publishing operations, including the profits from its yellow pages advertising, were included in its rate base in an effort to keep local telephone rates low.

At divestiture, U S West transferred its directory publishing assets to the unregulated entity U S West Direct and sought to reduce or eliminate payments from directory advertising to support regulated local rates. A number of state commissions confronted U S West in courtroom and administrative proceedings. For example, the Iowa Utilities Board found that the transfer of directory operations from Northwestern Bell jeopardized the goal of using directory publishing profits to support reasonably priced local telephone service.[11] In 1989, regulators from several states in the U S West region filed documents in the ongoing proceeding designed to enforce the Modification of Final Judgment ("MFJ"). In its "Advice to the Court," the state commissioners attacked "The U S West policy to offer no revenue support from U S West Direct to the telephone operations of the company. . . as a blatant subversion of the stated objectives of the [MFJ] Court's orders in this proceeding."[12] An attachment to the filing documented state regulators' efforts to require U S West to meet its regulatory responsibilities.

2.2. The merger would increase the ILEC's ability to circumvent regulation

The merger of Qwest and U S West would greatly and suddenly increase the scope and size of the ILEC's operations in markets and services that are not currently regulated at the state level. Qwest's current operations in collocation and remote access, internet access and web hosting

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[10] "Sol Trujillo Commits US WEST to Improved Service", News Release, Oct. 25, 1999, at http://www.uswest.com/news/102599.html.

[11] U S West Communications, Inc., 152 P.U.R.4th 446 (Iowa 1994). Final Decision and Order Synopsis, n.1, §3.

[12] U.S. v. Western Elec. Co., Inc., Civil Action No. 82-0192, "Advice to the Court by the Western Conference of Public Service Commissioners Amici Curiae Regarding the Enforcement of the Order on Modification of Final Judgement Dated August 11, 1982," at p. 5, no. 8 (filed Oct. 23, 1989).

services, wireless and video services, and out-of-region long distance services would be added to U S West's current in-region operations. Overall, the merger would increase the firm's total assets from $18.4 billion (pre-merger U S West) to $27.5 billion post-merger in terms of book-value[13] and from $36.5 billion (pre-merger U S West) to $65 billion post-merger in terms of stock-market valuation.[14]

This abrupt expansion in size and scope of the regulated firm would correspondingly increase the extent of informational asymmetries between regulators and the ILEC and, more generally, the complexity of the tasks faced by regulators. This problem would be particularly severe for state regulators. It is unlikely that it would be optimal for regulators to spend enough additional resources (in monitoring and evaluating the ILEC's behavior) to bring complexity and informational asymmetries back to pre-merger levels.[15] It is even less likely that it would be optimal, or even feasible, for the regulators to adjust immediately to the sudden change caused by the merger.

As a consequence, at least for some time, state regulators may lack the experience and resources necessary to evaluate the potential synergies between the new or greatly expanded activities and the regulated parts of the ILEC's business. During this period the ILEC would gain greater leeway to impute disproportionate amounts of its total costs to its regulated activities and thereby obtain undue increases in its profits. Where the ILEC is regulated on a cost basis, the ILEC would realize this increased return directly, and in jurisdictions where it is subject to incentive regulation the increased returns would be reaped via increases in price-caps or decreases in X-factors. For the same reasons, the merger would also increase the ILEC's ability to bias its choice of technologies towards those that have high synergies with the (new) unregulated activities.

I have recalled the controversy about directory publishing in the previous section. Regardless of the merits in this specific matter, it is a clear illustration that determining and *enforcing* the

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[13] The data are from U S West's and Qwest's 1998 Annual Reports as posted on their websites at http://www.uswest.com/is/annuals/annual98/index.html and http://www.qwest.com/annual_report98/index.html

[14] U S West's merger presentation, at http://www.qwest.net/qwest/index.html.

[15] It would probably be optimal to spend *some* additional resources. Another regulatory response to the decreased precision of information about the ILEC's cost structure would be to rely more heavily on incentive regulation and, especially if the loss of precision comes with an expanded range of possible outcomes, leave more informational rents to the firm. For a formal analysis, see J.J. Laffont and J. Tirole, *A Theory of Incentives in Procurement and Regulation*, The MIT Press, Cambridge, MA, 1993, especially Appendix A1.6 (pp. 123-124), Section 12.3.1 (pp. 519-524) and Section 12.4.1 (pp. 528-529).

appropriate boundaries between regulated and unregulated activities can be problematic even for cases as apparently simple as directory publishing. The proposed merger would confront regulators with much harder cases.

2.3. The merger would increase the ILEC's incentives to divert resources

The main reason why the merger would increase the ILEC's incentive to divert resources is that the merger would make it easier for the ILEC to invest in Qwest's projects.

The incentive for the ILEC to invest in Qwest-like projects (instead of investing, say, in projects that enhance ILEC service quality) is arguably present even without the merger. If there were Qwest-like projects available to the ILEC in the market,[16] the ILEC were not financially constrained, and the ILEC had a comparative advantage in financing them, it would have invested in those projects. U S West was not financially constrained, since it paid out dividends of $4.1 billion in the years 1995-1998.[17] Therefore, either the ILEC had no comparative advantage in financing those Qwest-like projects or such projects were not available.

The merger would make such projects available to the ILEC. Moreover, by eliminating the boundaries between the two firms, the merger may reduce the agency costs associated with financing those projects with the ILEC's revenues.[18] This could lead to an inefficient diversion of resources from regulated to unregulated investments.

This diversion of resources is all the more likely because Qwest is placing great importance on the opportunity to use U S West's financial resources after the merger. The Applicants have announced that the merged firm would aggressively pursue a strategy of diverting U S West's revenues (mainly from regulated activities) to finance Qwest's investments (mainly into unregulated activities). They plan to slash the annual dividend on U S West's stock from more

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[16] That is, those not legally proscribed. Section 271 of the Telecommunications Act of 1996 prevents RBOCs from making significant investments in companies that provide in-region long-distance service.

[17] Computed from historical dividend information in U S West's web site at http://www.uswest.com/is/dividends/information.html.

[18] In a competitive environment this reduction in agency costs would count as an efficiency benefit of the merger, but the ILEC's environment is one of market power and regulation. In this second-best context, the agency costs of outside financing may be a compensating factor for the divergence between the private and social value of the ILEC's investments.

than two dollars per share to a nickel per share after the merger closes.[19] The companies estimate that this reduction in the dividend, along with certain "capital expenditure synergies," will free up $7.5 billion for future investment. Qwest explained the theory of the deal as follows:

> "We believe we will be able to redeploy our capital in the years 2000 through 2005 in the aggregate amount of approximately $7.5 billion toward new investment in Internet applications and hosting, out-of-region facilities based competitive local exchange service, out-of-region broadband access and Internet services, wireless expansion and video entertainment. We believe we can fund this redeployment of capital with approximately $5.3 billion of savings from the reduction in the dividends currently paid by U S West and $2.2 billion of savings from capital expenditure synergies."[20]

The plan to stop paying almost all dividends and invest them in Qwest's business is a signal that Qwest is facing difficulties in getting funds from the financial markets. It also suggests that the Applicants will go further than simply stopping the payment of dividends and actually redirect some of the funds that would have been invested in U S West's in-region local network towards Qwest's (mainly out-of-region) network.

Moreover, when exceptional or unexpected problems in the local network occur the availability of liquid funds enables an ILEC to take prompt remedial actions. One consequence of the merger would be the commitment of U S West's liquidity to Qwest's projects, eliminating an important financial buffer and reducing the ILEC's incentives to cope with rare, but eventually inevitable events.

2.4. The merger would increase the ILEC's incentives to degrade service quality to other carriers and thus to consumers

The most straightforward reason why the merger would increase the ILEC's incentive to degrade service quality is that it would increase the ILEC's incentive to divert resources from quality-enhancing investments to Qwest's high-speed data projects. I have discussed this incentive in the

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[19]Compare Qwest Communications International Inc. Form S-4 (Qwest S-4), filed with the Securities and Exchange Commission on August 13, 1999, at 75 (listing historic dividends paid on U S West shares) with id. at 72 (stating that the quarterly dividend on the stock after the merger will be $0.0125, or five cents per year).

[20] See Qwest S-4 at 28.

previous section of this report. There are, in addition, other more subtle reasons that are related to the vertical nature of the merger[21] and to the ILEC's increased incentive to raise rivals' costs.[22]

For example, consider the quality of access service the ILEC provides to IXCs on calls terminating in U S West's region. Pre-merger, the ILEC's incentive to provide good service quality to IXCs depends essentially on the maximum access charges that the ILEC can levy on IXCs and on the elasticity of the IXCs' demand for access. If regulation keeps access charges close to the cost of providing access, the ILEC will provide a sub-optimal level of service quality and the quality level will be lower if access demand is relatively inelastic.[23] However, pre-merger the ILEC does not have any incentive to discriminate against any particular IXC.

After the merger, Qwest's out-of-region interLATA operations will become a division of the ILEC. The profits of this IXC division will generally increase if competing IXCs' costs of providing quality service rise. For these competitors the costs of providing quality service depend in part on the quality of access service provided them by the ILEC for calls terminating in its own region. Therefore, the merger will increase the incentive to further degrade quality of access to competing IXCs.[24] In turn, this will translate into higher prices for out-of-region consumers and lower quality for all consumers on inter-regional calls.[25]

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[21] The Applicants claim in their Reply Comments that the proposed merger is purely vertical and that it does not pose competitive issues. I disagree on both counts, but in this document I will only address the potential anticompetitive effects due to the vertical aspects of this merger.

[22] See J.A. Ordover and G. Saloner, "Predation, Monopolization, and Antitrust" in *Handbook of Industrial Organization*, Vol I, pp. 565-570 (R. Schmalensee and R.D. Willig, eds., 1989) for an introduction to the literature on this topic.

[23] This is another example of under-provision of quality by a monopolist subject to price-cap regulation.

[24] The merger would also induce the ILEC to provide better service quality to its own IXC division (i.e., pre-merger Qwest), but the net effect of the distortion on consumers' welfare will be negative. The merger would not increase consumer welfare via any increase in the number of firms operating in any market, since Qwest already offers out-of-region long distance service and the merged entity would not be able to offer in-region long distance service.

[25] For a formal model along these lines, see D. Reiffen, "A Regulated Firm's Incentive to Discriminate: A Reevaluation and Extension of Weisman's Result" in Journal of Regulatory Economics, vol. 14, n. 1, July 1998, pp. 79-86.

The harm to in-region consumers, however, may be even higher. The ILEC must take care that the lower quality of service provided to in-region consumers does not induce them to switch to a CLEC that has maintained good access quality to all IXCs. Possibly the cheapest way to retain these customers is to reduce the competitiveness of in-region CLECs by degrading the quality of their interconnection with the ILEC. This would further harm all in-region consumers, but would disproportionately harm customers of the CLECs.[26] Thus, the ILEC's customers would be unwilling to switch to a CLEC in spite of the ILEC's low quality of service - indeed, partly because of it![27]

In sum, the ILEC's incentive to discriminate against IXCs who compete with Qwest out-of-region has the further effect of increasing the ILEC's incentive to strengthen its power in the market for in-region local calls. Both incentives work to decrease the overall quality of service enjoyed by consumers in the ILEC's region.

I have described the ILEC's incentives to degrade service quality in terms of local and long-distance calls. The same argument would apply *a fortiori* to the in-region provision of 800-number services and private line services and to the in-region provision of any advanced services that require use of the ILEC's network (e.g., DSL service, now offered predominantly by U S West, and high-speed broadband Internet access service, offered by Qwest), where the ILEC's influence on rivals' costs is even greater.

2.5. Incentives to obtain interLATA relief

The Applicants have claimed that the merger itself would increase the ILEC's incentives to open its markets to competition because it would increase the incentives to obtain relief from the

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[26] Because the ILEC has a much larger market share than all other CLECs combined most of the calls made by the ILEC's consumers are made to other consumers that are served by the ILEC and are not affected by the quality degradation. On the contrary, most of the calls from CLECs' consumers would suffer the quality degradation precisely because they are directed to ILEC's consumers and depend on the quality of interconnection. For a formal model, see the technical appendices of J. Crémer, P. Rey and J. Tirole, "The degradation of quality and the domination of the Internet," mimeo, 1998, prepared for counsel of GTE in the matter of MCI-WorldCom merger.

[27] The CLEC could decrease its reliance on the quality of the ILEC's services by reaching more consumers directly with its own new facilities. But this would often involve inefficient duplication of facilities, higher costs and ultimately higher prices that would dissuade consumers from switching.

interLATA restrictions in Section 271 of the Telecommunications Act of 1996.[28] The arguments they adduce, however, are unconvincing. First, even if the incentive to obtain interLATA relief were to *increase* with the proposed merger, it would not follow the ILEC would have *sufficient* incentives to open up its markets to competition and/or to spend resources to accelerate such opening. The ILEC may still find that it is profit-maximizing to do as little as possible to open its markets to competition. Second, as shown in the previous section, the merger would strengthen some of the ILEC's incentives to foreclose entry in the local exchange market and thus weaken the ILEC's incentive to take the measures necessary to obtain interLATA relief.

The reasons for increased incentives to obtain interLATA relief mentioned by the Applicants do not seem sufficiently strong to reverse the negative effects mentioned above. In particular, one part of the analysis they have presented in support to their claims is seriously flawed. In his declaration accompanying the Applicants' Response Comments, Bruce Owen states that,

> "The combined company can expect *greater* net profits from satisfying Section 271 than U S West alone could expect for three reasons:
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> First, and probably most important, the combined company will already have a nationwide network with substantial capacity, while U S West entering on its own would have to obtain national network capacity at prevailing market prices or through new construction. [...] In considering the profitability of attracting long distance traffic, the combined company would not take into account the cost of the capacity, because that cost is already sunk." (p. 9; italics in the original)

But, although Qwest's capacity may be sunk in the ground, its cost is *not* sunk because that capacity can be used without linking it to U S West's assets. The opportunity cost of that capacity is its value in the best alternative use, i.e., its market value. This market value would enter the combined company's calculations of the profitability of attracting long distance traffic. Owen's argument implicitly assumes that the merger would reduce the market price of capacity to zero.[29]

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[28] See the Applicants' "Response to Comments on Applications for Transfer of Control" filed on October 18, 1999 in FCC CC Docket No. 99-272) and, in particular, the declaration by Bruce Owen (attachment B).

[29] Alternatively, Owen may have assumed that (pre-merger) U S West can buy capacity at market prices, but (post-merger) Qwest cannot sell it. This assumption could be justified only if US West was the only potential buyer of Qwest's capacity, i.e., if Qwest's capacity could be of use only to U S West. There is no evidence to suggest that this is the case.

The Applicants, however, have not provided any reason why the merger would decrease the market value of Qwest's network at all.[30]

3. EFFICIENCIES

The Applicants have not provided sufficient information to properly evaluate their efficiency claims. Indeed, according to the declaration of Dennis W. Carlton and Hal S. Sider submitted to the Commission on behalf of the Applicants,[31] "the companies have not yet fully determined exactly how such opportunities [to realize a variety of efficiencies] are to be pursued." Carlton and Sider apparently only claim that "the transaction creates possibilities for efficiencies that otherwise would not exist." [32] In the absence of further details, I comment below on the possibilities mentioned by Carlton and Sider.

3.1. On the claim that the merger would put together "complementary managerial skills"

Carlton and Sider claim that the merger would improve efficiency because it would put together "complementary managerial skills," Qwest's dynamism in new services deployment and U S West's experience with mass markets. [33] One might equally well argue that the differences in corporate culture between the two companies (a young high-growth company and an established low-growth monopoly) could create more troubles than opportunities. Both claims are as hard to refute as they are hard to substantiate.

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[30] On the contrary, the analysis in M. H. Riordan, "Anticompetitive Vertical Integration by a Dominant Firm" in *American Economic Review*, vol. 88, no. 5 (December 1998), pp. 1232-1248, suggests that the price change is likely to be small and positive. The merger would prevent the ILEC's use of Qwest's network for interLATA transport until interLATA relief is obtained, but this does not affect the argument of this section.

[31] Attachment A to the Applicants' "Response to Comments on Applications for Transfer of Control," (hereinafter "Carlton and Sider") p. 8.

[32] Carlton and Sider, p.8.

[33] Carlton and Sider, p. 8.

3.2. On the claim that the merger would put together "complementary physical assets."

Carlton and Sider claim that the merger would improve efficiency because it would put together "complementary physical assets" such as Qwest's high-speed broadband network and U S West's DSL capabilities.[34] High-speed networks and DSL service are indeed complementary goods, but complementarity (in production and/or consumption) is not sufficient ground for claiming merger efficiencies. The Applicants should show that the complementarity could not be exploited by contractual means. As far as we know, U S West's DSL equipment has no specific complementarity with Qwest's network and could be connected equally well to the networks managed by Qwest's competitors such as AT&T, MCI/Worldcom, Sprint, or GlobalCrossing/Frontier. Similarly, Qwest's network could be connected with the DSL equipment of other carriers. In other words, although the relevant assets are complementary, they are not "specific" in the sense of Williamson.[35] Therefore the merger would not provide any opportunities for achieving efficiencies in this regard.

Moreover, even if some efficiencies could be realized by joining the two kind of assets under the same ownership, the main beneficiaries would be consumers outside U S West's region, because Section 271 would not allow Qwest to offer interLATA data (Internet) transport to in-region consumers.[36]

3.3. On the claim that the merger would "improve planning and deployment of new network services."

Given the discussion of the previous point, it is not clear what kind of in-region network services this claim refers to.

[34] Carlton and Sider, p. 9.

[35] See O. E. Williamson, "Transaction Cost Economics" in *Handbook of Industrial Organization*, Vol I, pp. 135-182, (R. Schmalensee and R. D. Willig, eds.), 1989.

[36] Carlton and Sider recognize that in-region consumers could only benefit if U S West gains interLATA authority under Section 271 (Carlton and Sider, page 9.)

3.4. On the claim that the merger would enable Qwest to "take advantage of U S West's large in-region customer base."

I am afraid that this claim is true. And it would not be to the advantage of those consumers, who would benefit much more if Qwest had to compete fairly with its competitors for their demand. The Applicants have not demonstrated that they need to merge in order for Qwest to provide these services to U S West's customers, as they could do so by contract or joint venture. To the extent that the merged firm would take advantage of U S West's customer base to obtain and use customer proprietary information to deploy services, it would enable U S West to disadvantage competing suppliers of applications services.

3.5. Conclusion

In sum, the Applicants have not provided any clear evidence that the merger would have significant efficiency benefits. Moreover, the mere potential for any such efficiencies vanishes when one takes into account the restrictions that Section 271 would impose on the merged entity. Indeed, the Applicants themselves have admitted as much in their merger application to the Commission: "The entire rationale of this transaction depends upon interLATA relief."[37]

4. SUGGESTED REMEDIES

The preceding analysis shows that the proposed Qwest/U S West merger would increase both the payoffs from circumventing regulation and the probability that the merged entity would be successful in doing so. As a consequence, the merged entity will be more likely to divert investments from the ILEC's to Qwest's businesses and to increase the ILEC's anticompetitive exploitation of its dominant position. Both kinds of actions would lead to the degradation of the quality of services provided to consumers (because of the decreased investments in the ILEC's network) and to competitors (because of anticompetitive conduct as well as decreased investments), thus harming consumers both directly and indirectly.

These adverse effects could be countered by a combination of two classes of remedies: (1) separation of the ILEC into two or more separate entities, and (2) increased monitoring of quality levels (to end-users and to other carriers) and/or higher penalties for non-compliance with (possibly enhanced) regulated quality standards.

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[37] Merger of Qwest Communications International Inc. and U S West, Inc., "Application For Transfer of Control," CC Docket No. 99-272; File No. 18-EX-TC-1999 et al, p. 17.

4.1. Structural separation

Separation is a matter of degree, both in its intensity (ranging from mere accounting separation to the creation of separate legal entities under different ownership) and in its extension, i.e., in the way in which the ILEC would be partitioned.[38] If separation is to have any significant effect, it must be sufficiently intense to remove the commonality of interests between the separated entities. Mere accounting separation would not be effective and the Commission should consider strong forms of structural separation.

Determining the most appropriate extension of the separation, i.e., the most appropriate way to partition the original ILEC, is a delicate task.[39] On one hand, an extensive separation removes a larger number of potentially anticompetitive incentives. On the other hand, it may also eliminate some asset ownership structures aimed at reducing transaction costs.

Possibly the least intrusive boundary for structural separation is the one between the ILEC's wholesale and retail activities. It would eliminate, almost by definition, the wholesale ILEC's incentive to discriminate against CLECs in favor of the ILEC's retail division. However, it would not fully eliminate the wholesale ILEC's incentives to discriminate against CLECs engaged in facilities-based competition, nor against competing IXCs.

4.2. Quality monitoring

Even the most complete form of structural separation would not fully eliminate the ILEC's incentives to supply a sub-optimal quality level. Therefore, it is important that the Commission also consider the adoption of an effective quality monitoring plan.

Designing an adequate monitoring and penalty structure is another difficult task, but fortunately it is not a task that needs to be approached from scratch. The Commission can make use of the performance measurements, benchmarks, and statistical methods that it adopted in approving the

[38] In principle, every element of the ILEC's network could be assigned to a different owner – even though, in practice, this would not be an efficient ownership structure.

[39] See FCC Memorandum Opinion and Order Adopted October 6, 1999, CC Docket No. 98-141, henceforth Opinion and Order.

SBC/Ameritech merger.[40] In spite of their differences, the SBC/Ameritech merger and the proposed Qwest/U S West merger raise common problems for competition in the local exchange markets that could be ameliorated by the imposition of similar conditions.[41]

The conditions in the Carrier-to-Carrier Performance Plan imposed on the SBC/Ameritech merger focus on preventing discrimination against CLECs because their basic goal is to improve the competitiveness of local exchange markets and thus allow market forces to provide consumers with services of appropriate quality and price. It must be recognized, however, that competition may not spread rapidly to some areas.[42] Since, as I argued above, the merger of U S West and Qwest poses a serious threat of diverting resources to the unregulated "advanced services" lines of business, consumers in those areas may suffer deterioration in the quality of service they get from the merged entity and remain without recourse to alternative providers. Therefore, I believe that it would be advisable to disapprove the merger unless the Applicants also commit to ensure good performance to end-users.

The conditions required by the Commission in approving the SBC/Ameritech merger also include the obligation to provide quarterly reports on retail service quality on a state-by-state basis in accordance with the recommendations of the NARUC Technology Policy Subgroup "Service Quality White Paper" (November 1998)[43] and with the ARMIS Report No. 43-05.[44] The Applicants should commit to a similar reporting requirement and to a system of enforceable penalties for any failing to meet a set of given performance goals.[45] The performance goals could be set on the basis of the performance of other ILECs as recorded, for example, in the ARMIS database. I refer to my joint declaration with Prof. Joseph Farrell in the SBC/Ameritech merger

[40] See Opinion and Order quoted above.

[41] On the basis of the Applicants' own claims, these conditions would not be a burden to the ILEC. Their satisfaction is practically necessary for the ILEC to obtain interLATA relief – and the Applicants claim that it would be in the ILEC's interest to obtain interLATA relief anyway.

[42] Especially in rural areas, widespread competition is unlikely before a competitively neutral mechanism of universal service subsidization becomes fully operative.

[43] Opinion and Order, pp. 168-169, at 403 and 753.

[44] Opinion and Order, p. 169, at 404 and ft. 756.

[45] In Minnesota, U S West has been subject to similar requirements that took effect January 1, 1999. See "U S West Communications, Inc. Modified Alternative Form of Regulation Plan for the State of Minnesota," filed on January 11, 1999, effective January 1, 1999.

proceeding[46] for a discussion of alternative ways to structure this kind of relative performance evaluation mechanism.

Action by the Commission to obtain enforceable commitments by Qwest and U S West to a set of conditions substantially equivalent to those adopted in the SBC/Ameritech merger would ensure that the ILEC met a uniform standard for opening its local markets to competition across the 14-state region. Moreover, adopting substantially the same conditions for this merger as have been required in ILEC-ILEC mergers would ensure that performance measures from these major ILECs are obtained under uniform regulatory conditions. Common performance requirements will increase the ability of the Commission and state regulators to "benchmark" ILEC performance in opening local markets to competition.[47]

4.3. Conclusion

I have suggested two types of remedies – structural separations and increased monitoring of service quality – to counteract the harm to consumers that the merger of Qwest and U S West would otherwise induce. The Applicants' commitment to these conditions and their effective implementation would advance the public interest and facilitate the Commission's approval of the merger.

[46] "Benchmarking and the Effects of ILEC Mergers," Declaration of Joseph Farrell and Bridger M. Mitchell, October 14, 1998, CC Docket No. 98-141.

[47] Benchmarking may be somewhat more complex if different ILECs are subject to different structural separation requirements, but this is unlikely to dilute its benefits significantly.

CERTIFICATE OF SERVICE

I, Carmen D. Minor, do hereby certify that on this 13th day of January, 2000, I have caused a copy of the foregoing ***EX PARTE*** filing to be served, via hand delivery or first class United States Mail, postage prepaid, upon the persons listed on the attached service list.

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