Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

In the Matter of	)	
	)	
Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	)	**WC Docket No. 02-112**
	)	
2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules	)	**CC Docket No. 00-175**

REPLY DECLARATION OF DENNIS W. CARLTON, HAL SIDER AND ALLAN SHAMPINE

July 28, 2003

I. INTRODUCTION AND SUMMARY

1. We submitted a declaration in this matter on June 30, 2003 that presented the bases for our conclusion that elimination of structural separation requirements preventing ILECs from fully integrating their long-distance and local exchange operations will not adversely affect long-distance competition. Our analysis indicated that there is no economic basis for subjecting BOCs' in-region long-distance service to dominant carrier regulation following the sunset of Section 272 structural separation requirements, nor is there any economic basis for conditioning the non-dominant status of independent LECs' long-distance operations on the structural separation of those operations. Our June 30 declaration contains a summary of our qualifications.

2. At the request of counsel for Qwest, Verizon and SBC, we address certain points raised in comments submitted by other parties in this matter. Our reply focuses on comments by AT&T and the supporting affidavit by Dr. Lee L. Selwyn, which support the imposition of dominant carrier regulation on ILEC-provided long-distance services. Many of the points raised by AT&T and Dr. Selwyn are representative of issues raised in other parties' comments. We focus on issues they raise that were not directly addressed in our June 30 declaration. Our failure to discuss the remaining claims made by AT&T or Dr. Selwyn should not be interpreted to suggest that we agree with their analysis or conclusion.

3. The FCC's Further Notice of Proposed Rulemaking (FNPRM) asked whether elimination of structural separation requirements would be likely to: (i) facilitate non-price discrimination by ILECs against their long-distance rivals; (ii) facilitate a predatory price squeeze by ILECs against their long-distance rivals; and/or (iii) enable ILECs to shift costs from long-distance to local operations in a manner that would adversely affect long-distance

competition. The FNPRM also inquired whether dominant carrier regulation would address these potential concerns.

4. Our prior declaration described the conditions under which such strategies might succeed and showed that such conditions do not exist in the long-distance industry. AT&T and Dr. Selwyn have not shown otherwise.

- Successful non-price discrimination in degrading access to rival long-distance carriers requires both that ILECs' efforts not be detected by regulators and rival long-distance providers and that they be sufficient to induce consumers to switch to ILEC-provided services. AT&T and Dr. Selwyn fail to establish that (i) these unlikely circumstances both occur; (ii) elimination of structural separation requirements facilitates the pursuit of non-price discrimination by ILECs; and (iii) imposition of dominant firm regulation would be a necessary or appropriate way to address this risk.
- Successful pursuit by ILECs of a predatory price squeeze against rival long-distance providers would require that ILECs set long-distance prices at a sufficiently low rate and for a sufficiently long time to drive their rivals from the industry. Successful predation also requires that these rivals not reenter the industry (and that others not enter) since such entry would prevent ILECs from recouping their investment in predation through higher prices. Our prior declaration explained that successful predation is rare and AT&T and Dr. Selwyn fail to establish that there are any realistic predation concerns in the long-distance industry, especially given the ability of consumers to use wireless services to make long-distance calls, or other alternatives such as e-mail, instant messaging and voice over IP. They further fail to show that imposition of dominant carrier

regulation is a necessary or appropriate way of preventing such an unlikely occurrence.

- With respect to potential concerns that cost shifting by ILECs from unregulated to regulated activities could adversely affect long-distance competition, AT&T and Dr. Selwyn fail to establish that an ILEC's ability to predate depends in any way on its ability to shift costs. As discussed in our prior declaration, if an ILEC could predate – and there is no evidence suggesting that this is a realistic possibility – its ability to do so would not depend on its ability to shift costs. Neither do AT&T or Dr. Selwyn establish that (i) cost shifting that does not result in predation adversely affects long-distance competition in any way, or (ii) dominant firm regulation is a necessary or appropriate way of addressing the matter. As we discussed in our prior declaration, there is little if any incentive for integrated carriers to shift costs because regulated rates for local services are largely set independently of the costs reported by ILECs due to price caps and other forms of incentive regulation.

II. ILECS HAVE NO INCENTIVE TO SET LONG-RUN PRICES FOR LONG - DISTANCE SERVICES AT A LEVEL THAT DRIVES EFFICIENT RIVALS FROM THE INDUSTRY OR TO ENGAGE IN PREDATION

A. ILECS HAVE NO INCENTIVE TO SET LONG-RUN PRICES THAT RESULT IN THE EXIT OF EFFICIENT RIVALS EVEN IF ACCESS CHARGES EXCEED ILECS' COST OF PROVIDING ACCESS

5. AT&T's comments suggest that ILECs have a long-run incentive to set prices below competitive levels and, as a result, drive even efficient long-distance rivals from the long-distance industry. Its arguments focus on its claim that the cost to ILECs of providing access is

below the access charge to long-distance carriers.[1] This concern is further reflected in AT&T's longer-term policy goals, which are described in Section IV of its comments:

> There is a critical need for comprehensive intercarrier compensation reform in order to remove the BOC access cost advantage resulting from the current system of above-cost interstate and intrastate switched access rates, and to reduce the BOCs' ability and incentives to engage in anticompetitive price squeezes, and other anticompetitive cross-subsidization.[2]

6. There is no basis to AT&T's claim. AT&T ignores the fact that ILECs lose access revenue when they provide long-distance services. That is, when ILECs provide long-distance service they gain retail revenue but lose access revenue paid by a subscriber's prior long-distance carrier. The loss in access revenue is a real cost of providing retail long-distance service faced by ILECs which must be considered in any evaluation of the prices charged by ILECs as long-distance carriers.

7. For example, assume that the cost to an ILEC of providing access to long-distance carriers (including itself) is zero but long-distance carriers face access charges of $.01 per minute.[3] If an ILEC, rather than an independent long-distance carrier, provides long-distance service through its own affiliate at the retail price of $.05 per minute, it gains retail revenue of $.05 per minute but loses access revenue of $.01 per minute that it otherwise would have earned. In deciding whether to provide, and how to price, long-distance service, the ILEC must take into account the potential loss of access revenue. Any such loss in access revenues from long-

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1. For the purpose of this discussion, we assume that AT&T's claim that access charges are above ILECs' cost of providing access is correct and show that AT&T's argument fails nonetheless. Regardless of whether AT&T's assumption has merit, the fact that the Commission regulates access prices indicates that it believes that such regulation typically results in prices lower than would otherwise occur.
2. Comments of AT&T Corp., p.68 (hereafter, AT&T Comments).
3. We recognize that there is a cost of providing access, but for simplicity we assume zero cost in this example. The conclusions in this section are not altered if a non-zero cost is assumed.

distance carriers is a real cost (which economists call an "opportunity cost"). In our example, the ILEC would profitably provide long-distance service if the additional \$.04 it earns by providing retail service (instead of access service alone) more than offsets the additional costs that it incurs in providing retail long-distance service. We refer to this \$.04 as the "retail margin."

8. Thus, the access charge of \$.01 represents a \$.01 opportunity cost faced by the ILEC when it induces a long-distance customer to switch to its own long-distance service for a call. The effective margin earned by the ILEC in providing retail long-distance service (instead of access alone) is only \$.04 per minute, the same net-of-access-cost margin the long-distance carrier earns (assuming it charges the same retail price). Thus, even if ILECs face costs of providing access that are less than the access charges paid by rival long-distance carriers, they have no long-run incentive to set price below \$.05 per minute, the level implied by their opportunity cost of access and other relevant costs of efficiently providing long-distance service. At any lower price, ILECs would fail to earn a price that covers all their relevant costs.

9. This logic implies that ILECs will not have an incentive to provide long-distance service if rival carriers are more efficient. For example, assume that an efficient long-distance carrier requires a retail margin (retail long-distance price minus access charges) of \$.04 to cover its relevant costs to provide long-distance service, while the ILEC requires a minimum retail margin of \$.05 (ignoring the access charges) to provide long-distance service. (Recall that, for simplicity's sake, we assume above that ILECs can provide access at zero cost.) The ILEC's higher costs may, for example, reflect the fact that its network is less efficient than the networks of other long-distance carriers.[4] In this example, the long-distance carrier would, by assumption,

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4. Betsy Barnard, President of AT&T noted, "'We have a significant advantage against any of the Bells… They don't have the assets, the networks, the services. It takes decades to build that capability." (Reinhardt Kraus, "Bernard Faces New Round of Challenges," Investor's

just cover its relevant costs of providing long-distance service (i.e., revenue of $.05 minus access charges of $.01 equals the required $.04 needed to cover relevant costs). The ILEC, however, would not cover its relevant costs including the opportunity cost of lost access fees if it provided the long-distance service instead (i.e., $.05 minus the opportunity cost of $.01 fails to cover the $.05 needed to cover the ILEC's relevant costs). Hence, the ILEC earns greater profits if its rivals provide long-distance service rather than itself (another way to establish this point is as follows: if rival long-distance carriers provide service, the ILEC earns $.01 in access charges, while if the ILEC provides the long-distance service itself, it earns nothing). As this example indicates, ILECs have no incentive to set the long-run price of long-distance service below the level implied by access charges and a competitive retail margin, and thus no incentive to drive more efficient long-distance rivals from the industry. [5]

10. For simplicity, the above discussion does not account for the expansion in output expected if long-distance prices were to fall below $.05.[6] This simplification, however, does not alter the basic conclusion that ILECs have no incentive to lower long-distance prices below the long-run competitive level (i.e., the level at which revenues cover relevant costs) and drive more efficient rivals from the industry in order to provide long-distance themselves. To see this point, assume that long-distance is competitive (in the sense that retail prices exceed access costs by an

(...continued)
Business Daily, July 21, 2003.)

5. Consumers would benefit if ILECs were to attempt to set prices below the long-run competitive level ($.05 per minute) as long as this investment could not be recouped by raising prices above the competitive level in the longer term. As discussed in our initial declaration and further below, it is highly unlikely that such recoupment would be possible in the long-distance industry.
6. The FCC raises this as a potential issue in its Opinion in the Matter of Regulating Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace, 12 FCC Rcd 15,756 (1997), ¶127 (hereafter, LEC Non-Dominance Order).

amount sufficient to enable long-distance carriers to earn only a competitive rate of return). Under these circumstances, if a reduction in access charges (and thus a reduction in retail rates) generated higher total access revenues as a result of higher usage, then ILECs would be expected to voluntarily reduce access charges, regardless of whether they also offer long-distance services. Because the FCC and states generally regulate the price of access (except for special access in areas where there is facilities-based competition), and long-distance carriers advocate such regulation, the FCC and long-distance carriers must believe that ILECs would increase access rates in the absence of regulation. (That is, if ILECs were not constrained by regulation, their profit-maximizing strategy would be to increase access fees, not to decrease them.) If that is so, ILECs would lose money by decreasing the price of access. Thus, there is no reason to expect that ILECs would set long-run prices below the level implied by access charges plus a competitive retail margin in order to drive more efficient long-distance rivals from the industry, even if output would expand at prices below $.05.

11. As this indicates, AT&T and Dr. Selwyn have not correctly identified the costs faced by ILECs in providing retail long-distance service. ILECs have no incentive to lower the long-run prices of long-distance services below the level implied by access charges and a competitive retail margin in order to provide the services themselves. As such, the success of long-distance carriers and ILECs in providing long-distance service will depend on which is more efficient.

B. ILECS DO NOT HAVE THE INCENTIVE OR ABILITY TO ENGAGE IN A PREDATORY PRICE SQUEEZE, EVEN IF ACCESS CHARGES EXCEED ILECS' COSTS OF PROVIDING ACCESS

12. Based on the mischaracterization of the effective costs faced by ILECs in providing long-distance services described above, AT&T and Dr. Selwyn argue that ILECs have the incentive and ability to engage in predatory price squeezes by setting retail long-distance

prices at or near access charges faced by their long-distance rivals.[7] This argument has no merit since above-cost access prices do not facilitate predation and cost-based access prices do not (by themselves) preclude predation.

13. As suggested above, regulated prices that long-distance carriers pay to access ILEC networks are one determinant of the retail price of long-distance services. Higher access charges result in higher costs to long-distance carriers and higher opportunity costs to ILECs when providing retail long-distance services, and thus higher long-distance prices charged by both ILECs and their rival carriers.

14. The level of the access charges faced by non-ILECs for originating and terminating calls does not affect an ILEC's incentive or ability to engage in a predatory price squeeze.[8] A predatory price squeeze requires that the ILEC charge a price below its rivals' costs (which include both access charges and any other relevant costs an efficient long-distance provider would face in providing service). An ILEC that pursues a predatory price squeeze "invests" by setting retail long-distance prices at below-cost levels (where costs reflect both access charges and other costs of providing long-distance service). Its low retail prices result in both a reduction in the ILEC's retail revenues (from existing retail customers) and its access revenues from other long-distance carriers when customers switch from rivals' long-distance services to its own.

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7. As summarized in the AT&T Comments (pp. 30-31), "[t]he BOCs also are using their special access bottlenecks to price squeeze IXC competitors … by raising the price of special access services to all interexchange carriers, thus causing competing IXCs … 'to either raise their retail rates … or … reducing their profit margin'." Also see AT&T Comments (p. 26).
8. This discussion treats long-distance as a single service. In fact, long-distance includes a variety of services such as interstate and intrastate long-distance. As discussed below, predation requires that prices be set below relevant costs for all services taken as a whole in order to drive rivals from the industry.

15. The fact that an ILEC might appear still to earn a positive accounting margin (defined as revenue less costs, ignoring lost access fees) by setting price below access charges is not relevant for evaluating whether predation makes economic sense. Even if the ILEC earned a positive accounting margin during a predatory price squeeze, it still must bear the cost of lost retail revenue and access revenue. Any attempt to engage in a predatory price squeeze also would likely require that retail prices be set below the appropriate measure of costs for an extended period of time. This in turn suggests that the "victims" of this strategy would have the opportunity to pursue complaints about such conduct, which further reduces the likelihood that such efforts could succeed.

16. For an ILEC to recoup its investment in predation, it would have to raise retail prices above the preexisting levels after rivals are driven from the industry. As discussed in our prior declaration, it is highly unlikely that a long-distance carrier could recoup any investment in predation due to the difficulty of precluding competition if prices were to rise above preexisting levels.

- Provision of long-distance service involves extensive use of fixed assets that would remain in the industry even if a service carrier became bankrupt. These assets would be available (probably at a fraction of their original cost) to any entrant and/or to firms that would emerge from bankruptcy proceedings resulting from below-cost pricing, as would the human capital (the workers) formerly employed by the bankrupt firm.
- In addition, the widespread use of wireless services for long-distance calling (as well as e-mail as a substitute for certain long-distance calls) adversely affects an ILEC's ability to recoup an investment in predation by raising long-distance price

after driving its rivals from the industry because certain calls will be lost to these other modes of communication.

- Successful recoupment subsequent to predation would be easily detectable and would likely trigger a regulatory response.

17. In sum, the level of access charges is irrelevant to an ILEC's ability to pursue a predatory price squeeze. This strategy is deterred by the difficulty the ILEC would face in recouping its investment in predation, not by the relationship between access charges and access costs (even if parties could agree on the correct measure of cost).

C. PER MINUTE CHARGES FOR INTRASTATE LONG-DISTANCE CALLS NEAR OR BELOW ACCESS CHARGES ARE NOT EVIDENCE OF A PREDATORY PRICE SQUEEZE

18. AT&T and Dr. Selwyn claim that BOCs are currently engaging in predatory price squeezes against their long-distance rivals. For example, AT&T claims that "BOCs are engaging in price squeezes by setting their long-distance rates at or below their switched access prices."[9] Citing Dr. Selwyn's declaration, AT&T claims that BOCs offer long-distance calling plans at rates equal to or below intrastate access prices in Texas, Virginia and Washington.[10]

19. The examples presented by AT&T and Dr. Selwyn, however, do not support their claims that BOCs are engaging in predatory price squeezes against their long-distance rivals.[11] A predatory price squeeze drives rival long-distance suppliers out of business. But if rivals provide many services (such as interstate and intrastate long-distance), predation can succeed only if the target firms are driven from the industry (i.e., if their total revenue fails to cover the total non-

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9. AT&T Comments, p. 26.
10. AT&T Comments, p. 27 citing Declaration of Lee L. Selwyn on behalf of AT&T, June 30, 2003, ¶¶43-48, 84-88, 96 (hereafter, Selwyn Declaration).
11. Curiously, Dr. Selwyn focuses on intrastate rates even though this inquiry deals with interstate rates.

sunk costs of long-distance service). More specifically, even if access prices exceed the per-minute component of price for some retail calls, this would not prove predation.

20. Long-distance services include a variety of types of calls including interstate/interLATA calls, intrastate/interLATA calls, and international calls to various destinations. Different types of calls may result in different costs to long-distance carriers. For example, access charges for intrastate calls vary across states and often differ from access charges for interstate calls. Long-distance carriers also may face higher costs for completing calls that travel longer distances.[12]

21. When firms offer a variety of diverse services, there are a variety of prices they can charge that enable them to cover costs. With respect to long-distance services, firms may well earn the same net-of-access-cost margin for interstate and intrastate calls (by charging different prices for these types of calls when access charges differ). Other carriers may choose to charge the same per-minute price for interstate and intrastate long-distance calls and earn different margins on each.

22. Presumably, long-distance carriers choose price schedules for different types of calls based on a variety of considerations including cost differences for different types of calls, the mix of calls made by their subscribers, and marketing considerations. For example, a long-distance carrier may determine that charging the same rate for interstate and intrastate long-distance calls may help attract customers.[13]

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12. For example, calls that cover longer distances occupy greater network capacity than calls that cover shorter distances.
13. We understand that if a company offers a plan that does not differentiate between interstate and intrastate long-distance, it is required to offer the same plan on the same terms in all states, even though intrastate access fees and other costs differ between states. Under Dr. Selwyn's theory, the company would be pricing predatorily if the per-minute charges were lower than the highest access cost in any state.

23. Under these circumstances it is not surprising that different firms adopt different pricing schedules. For example, some long-distance carriers charge the same per-minute rates for interstate and intrastate long-distance calls even when access fees differ.[14] Similarly, some plans charge more for calls that cover greater distance (within the U.S. mainland) while other plans do not.[15] The relevant question for evaluating predation, however, is whether revenue for all services taken as a whole exceeds the relevant costs in providing all services.

24. More generally, "below-cost" pricing for only one of multiple dimensions of service (e.g., intrastate long-distance calls in one state) does not imply that a firm is engaged in predation. Instead, predation requires first that prices be set at a sufficiently low level that rival firms are driven from the industry. This requires analysis of whether the revenue for all services taken as a whole exceeds the relevant costs incurred in providing those services. While Dr. Selwyn claims that per-minute charges below access rates for <u>intrastate</u> calls alone reflect an anticompetitive price squeeze, he is wrong. As he acknowledges in other parts of his analysis, it is inappropriate to consider interstate and intrastate interLATA calls as separate services.[16]

25. Similarly, since the mix of services consumed by different customers will vary, there may be differences in the profitability of serving different customers when the margins for each of the individual services in the package differ. However, the profitability of any given customer is not relevant for analyzing predation, which again requires that prices be set

14. For example, AT&T's "One Rate USA" and "Unlimited" plans charge the same per-minute fees for intrastate and interstate calls, while its "5 cent nights" and "5 cent weekend" plans do not.
15. See, for example, Sprint's "Dial 1" and "The Most II" services.
16. Selwyn Declaration, pp. 37-38, states: "Customers cannot and do not make separate service provider selections *notwithstanding the fact that the two services are subject to different regulatory treatment by different regulatory authorities and may be offered at different prices."* (Emphasis in original.)

sufficiently low across a sufficiently broad range of customers that rival firms cannot cover their costs and are therefore driven from the industry.

26. Any evaluation of predation must also include fixed monthly charges (which are often accompanied by lower per-minute charges) that are a standard element in many long-distance pricing plans. Evaluation of an alleged predatory price squeeze must consider both aspects of pricing. For example, an ILEC could charge a fixed monthly charge with no per-minute charges for a fixed bundle of long-distance minutes.[17] If so, it would be inappropriate to conclude that the ILEC was engaged in a price squeeze simply because the per-minute aspect of price was zero and therefore below the per-minute access charge. However, this is precisely what would be implied by AT&T's and Dr. Selwyn's analysis. Instead, the presence of such a plan would more likely be an effort to offer a pricing package that would be attractive to a segment of (presumably high-use) subscribers.

27. Significantly, neither AT&T nor Dr. Selwyn has claimed or presented any evidence that ILECs' long-distance service taken as a whole (including interstate, intrastate and international services) is priced below cost. Given the lack of such evidence and the difficulty of recoupment, the AT&T claim that ILECs are now engaged in predatory price squeezes should be dismissed.

III. AT&T INCORRECTLY SUGGESTS THAT ILEC OFFERS OF LOCAL/LONG-DISTANCE SERVICE BUNDLES ADVERSELY AFFECT LONG-DISTANCE COMPETITION AND REQUIRE DOMINANT FIRM REGULATION

28. AT&T and Dr. Selwyn focus on recent marketing developments in the telecommunications industry to support their argument that ILECs' provision of long-distance services should be subject to dominant carrier regulation after sunset of structural separation

17. We understand that most carriers offer such plans.

rules. Bundled local/long-distance services have been introduced in recent months by both CLECs as well as ILECs (in certain states in which they are authorized to provide long-distance services). Bundled service offerings typically provide local service and a fixed (or even unlimited) number of long-distance minutes for a fixed monthly fee. For example, AT&T's "One Rate USA" plan and MCI's "Neighborhood Complete" plans provide unlimited local and long-distance calling as well as certain vertical services for $49.95 and $49.99 per month, respectively, in most states where they are offered. (MCI offers its "Neighborhood Complete" plan for $39.99 per month in California.) Verizon's "Freedom" plan offers these services for $59.95 per month.[18]

29. Generally, the success of bundled packages reflects the fact that some consumers find them attractive economic alternatives to non-bundled services and there is no basis to view them as anticompetitive devices. Indeed, CLECs themselves began offering bundled packages of local and long-distance service before the BOCs were legally able to do so. Moreover, CLECs continue to aggressively market such packages in the Ameritech region, where SBC has not yet received interLATA authority and thus cannot itself offer similar packages.

30. The FCC has previously recognized in other circumstances that bundled services can result in consumer benefits and that they carry low risk of anticompetitive behavior. In an order permitting ILECs to bundle local exchange service and CPE, the FCC concluded:

> [W]e conclude, in light of the existing circumstances in these markets, that the risk of anticompetitive behavior by the incumbent LEC in bundling CPE and local exchange service is low and is outweighed by the consumer benefits of allowing such bundling. We view the risk as low not only because of the economic difficulty that even dominant carriers face in attempting to link forcibly the

18. These rates may differ between states.

> purchase of one component to another, but also because of the safeguards that currently exist to protect against this behavior.[19]

31. Dr. Selwyn, however, argues that bundled service offerings "inextricably" link local exchange services and long-distance services, and because local exchange services are regulated this "requires that the BOC long-distance affiliates themselves be classified and regulated as dominant carriers."[20] He further argues that "only IXCs that bundle local and long-distance services together into the same package can compete" with ILEC bundled service offerings.

32. There is no basis for these claims. Bundled local/long-distance services offered by ILECs and CLECs compete not only with each other but also with local services and long-distance services offered on an unbundled basis and with bundled services offered by wireless carriers. The majority of subscribers still obtain local and long-distance services on an unbundled basis. Thus, the prices charged for bundled services are constrained by the prices of the component services. A consumer will choose the bundled service only if it is more attractive than purchases of the component services on an individual basis. Furthermore, since long-distance carriers were legally able to (and did) introduce local/long-distance bundles before BOCs did, it is difficult to see how they can now claim to be disadvantaged when BOCs respond with their own bundles, since, according to AT&T's logic, only BOCs that offer bundled services could compete with long-distance carriers' bundled service offerings.

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19. FCC, Policy and Rules Concerning the Interstate, Interexchange Marketplace, 23 CR 641, 16 FCC Rcd 7418 (2001), ¶33.
20. Selwyn Declaration, p. 47.

33. AT&T also asserts that (i) local/long-distance bundles facilitate ILECs' ability to engage in a predatory price squeeze; and that (ii) local/long-distance bundles facilitate anticompetitive cost shifting.[21] There is no basis for these claims.

- The fact that services are bundled does not alter the fact that a predatory price squeeze would require driving rival long-distance firms from the industry and subsequently raising price. For the reasons discussed in our prior declaration and above, it is highly unlikely that such a predatory strategy would succeed because of the difficulty of recoupment. Both the availability of wireless services (as well as e-mail and instant messaging which are substitutes for certain long-distance calls) and the difficulty of preventing reentry of existing rivals and entry of new firms make it highly unlikely that investments in predation could be recouped.
- The emergence of bundled service would not facilitate cost shifting that would result in predation. As discussed in our prior declaration, there is no basis to conclude that the ability to shift costs facilitates a predatory price squeeze. The fact that some consumers prefer bundles does not alter this conclusion. Moreover, as explained in our prior declaration, there is no basis to conclude that cost shifting would result in greater ILEC revenue for local service in the presence of price caps.

34. Given the benefits of bundles for consumers, the lack of incentive for ILECs to drive efficient long-distance rivals from the industry, and the difficulty of recouping any investment in predation, there is no basis to view bundles as anticompetitive. Under these

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21. AT&T Comments, p. 65.

circumstances, the consequence of regulatory proceedings to determine whether tariffed rates for bundles cover relevant costs would be to chill competition and harm consumers.

IV. CHANGES IN LONG-DISTANCE SINCE 1997 PROVIDE NO SUPPORT FOR IMPOSITION OF DOMINANT CARRIER REGULATION ON ILEC LONG-DISTANCE SERVICES

35. In 1997, the FCC found that ILECs' long-distance affiliates should not be classified as dominant carriers simply because ILECs remained significant providers of local services. The Commission also concluded that dominant carrier regulation did not address the potential concerns arising from BOCs' integration in the provision of local and long-distance services, including non-price discrimination against rival long-distance carriers, predatory price squeezes, and cost shifting.[22]

36. AT&T now argues that the FCC's conclusions in its 1997 LEC Non-Dominance Order no longer apply due in part to changes in market circumstances, including weakened financial strength of rival long-distance carriers, which AT&T claims leaves them less able than the ILECs to provide bundled service offerings.[23] AT&T also claims that BOCs' success in obtaining wireline long-distance subscribers requires application of dominant carrier regulation. This section shows that there is no merit to either of these claims.

A. ILECS FACE INCREASED, NOT DECREASED, LONG-DISTANCE COMPETITION

37. As discussed in our prior declaration, ILECs face long-distance competition from a number of large national carriers that control vast networks, including several new fiber optic networks that did not exist in 1997. In our prior declaration, for example, we demonstrated that

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22. LEC Non-Dominance Order, ¶¶6-7.
23. AT&T Comments, p.57.

the provision of wireline long-distance services is far less concentrated today than it was when AT&T was granted non-dominant carrier status.

38. Moreover, by a variety of measures, the broader telecommunications industry is also more competitive today than in 1997. For example, in recent years not only has the concentration of wireline long-distance services fallen, but new services, including wireless phones and Internet services, have achieved extraordinarily rapid increases in penetration. These new technologies have introduced significant new intermodal competition to the long-distance industry. As a result, wireline long-distance usage and prices have fallen substantially in recent years. While these events have led to weaker financial performance and even bankruptcies among some telecommunications carriers, such events are evidence of increased long-distance competition, not a diminution of competition.

39. AT&T suggests that financial weakness on the part of some companies may make them more vulnerable to predation. However, as we discussed in our prior declaration, even if a company goes bankrupt, its assets will remain in the industry, making recoupment of any investment in predation highly unlikely. Global Crossing, GST and others have been through bankruptcies with their assets remaining in the industry after having been purchased by others at a fraction of their original cost. The same will be true of MCI: either it will emerge from bankruptcy and compete, or its assets will be acquired and used by others to provide similar services.

B. BOCS' SUCCESS IN GAINING LONG-DISTANCE CUSTOMERS DOES NOT JUSTIFY IMPOSITION OF DOMINANT CARRIER REGULATION

40. AT&T and Dr. Selwyn suggest that BOCs' share of wireline long-distance subscribers provides further justification for imposition of dominant carrier regulation. However, their discussion fails to consider the increased intermodal competition from wireless

and Internet services. They also fail to note the rapid decline in the concentration of wireline services and the fact that BOCs' shares (in states where long-distance authority was granted nearly three years ago) are well below AT&T's at the time that it was declared to be a non-dominant carrier.

41. While AT&T and Dr. Selwyn suggest that BOCs' shares of long-distance will continue to increase, this assertion, even if true, is not necessarily indicative of market power. Indeed, AT&T itself has argued, and the Commission has found, that a high market share is not indicative of market power if elasticities of supply and demand are high. In any event, as discussed in our prior declaration, the share of BOC customers that take BOC-provided long-distance service grows rapidly for roughly two years after the BOC achieves long-distance authority in a state but generally stabilizes after that. That declaration showed that analysts also project that BOCs' share of long-distance subscribers will stabilize at levels far below those projected by AT&T and Dr. Selwyn.

42. AT&T and Dr. Selwyn attribute BOCs' success in gaining long-distance subscribers following authorization to provide these services to their "ability to exploit their inbound marketing channel and offer pricing plans ignoring the cost of access …"[24] They argue that these advantages allow BOCs to charge lower prices, which harm the long-distance carriers by taking large numbers of customers from them and forcing them to lower their own prices. However, AT&T confuses harm to competitors and harm to competition.

43. AT&T and Dr. Selwyn mischaracterize the costs faced by ILECs in providing long-distance service and mistake procompetitive efficiencies with anticompetitive behavior.

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24. Selwyn Declaration, pp. 52-53.

When providing their own long-distance services, ILECs lose access revenue previously earned from rival long-distance carriers. This reflects a real loss in revenue to ILECs that will be considered in any price determination by a profit-maximizing firm. Thus, it is simply incorrect for AT&T and Dr. Selwyn to claim that ILECs can "ignore the cost of access" in pricing long-distance services.

44. To the extent that ILECs have been successful in gaining long-distance customers due to their ability to market to their existing customer base, then this reflects a procompetitive efficiency. If firms that jointly market both local and long-distance service can realize lower costs of customer acquisition and marketing, then this reflects realization of economic efficiencies. While firms that are less efficient marketers may lose customers as a result, this reflects the results of the competitive process, not harm to competition.[25] Both the BOCs' and long-distance companies' experiences in introducing bundled services to the marketplace indicate that consumers often prefer the convenience of a bundled long-distance/local offering.

C. THE FCC'S 1997 CONCLUSION THAT DOMINANT CARRIER REGULATION WOULD NOT ADDRESS POTENTIAL COMPETITIVE CONCERNS REMAINS VALID

45. The FCC concluded in 1997 that dominant carrier regulation of BOC in-region affiliates "generally would not help to prevent improper allocations of costs, discrimination by the BOCs against rivals of their interLATA affiliates, or price squeezes…"[26] The FCC's decision

25. Dr. Selwyn complains that long-distance margins are being reduced. However, that is not the issue because competition reduces margins, which is beneficial to consumers. The issue here is whether margins are reduced to predatory levels (in the sense that positive margins would be eliminated).
26. FCC, LEC Non-Dominance Order, ¶6. The FCC notes in ¶111 of this Order that "For purposes of determining whether the BOC interLATA affiliates should be classified as dominant, however, we need to consider only whether a BOC could discriminate against its affiliate's interLATA competitors to such an extent that the affiliate would gain the ability to

holds true even after expiration of structural separation requirements. As discussed in our prior declaration, dominant carrier rules are generally designed to prevent price increases, not attempts to set below-cost prices. They do not affect the ability of consumers, rivals or regulators to detect non-price discrimination, and they do not address predation concerns.

46. Dominant carrier regulation simply does not address the competitive concerns raised by AT&T, including non-price discrimination, cost shifting and predatory price squeezes. AT&T also has presented no evidence that elimination of structural separation rules in related circumstances has resulted in competitive problems.

47. Nonetheless, AT&T argues that imposition of dominant carrier regulation on ILEC-provided long-distance services would impose little if any burden on ILECs.[27] However, AT&T and Dr. Selwyn fail to rebut the Commission's prior conclusion that dominant carrier regulation can adversely affect long-distance competition. As we discussed in our prior declaration, the FCC has found, correctly in our view, that dominant carrier regulations can deter competition by, among other things: discouraging the introduction of innovative new service offerings; reducing the ability of firms to engage in price competition, including offering secret discounts; limiting the ability of firms to rapidly respond to changes in market conditions; and deterring firms from developing customer-specific service offerings.[28]

(...continued)
raise prices by restricting its own output upon entry or shortly thereafter."

27. AT&T Comments, p. 73.

28. FCC, Policy and Rules Concerning the Interstate, Interexchange Marketplace, 11 FCC Rcd. 20, 730 at ¶23, 53.

V. RESPONSES TO ADDITIONAL POINTS RAISED BY AT&T

A. THERE IS NO BASIS FOR AT&T'S VIEW THAT ILEC PARTICIPATION IN ADJACENT MARKETS IS INHERENTLY ANTICOMPETITIVE

48. AT&T's comments suggest that ILEC provision of telecommunications services such as long-distance that rely on the local exchange is inherently anticompetitive. It argues that "ILEC control of the local bottleneck confers market power in all downstream markets."[29] We disagree.

49. As noted in our prior declaration, there is ample history that contradicts this blanket claim and shows that AT&T's claimed distrust of ILEC participation in downstream markets is unwarranted. The FCC has previously concluded that ILEC provision of a variety of ancillary services, including customer premises equipment (CPE), various enhanced services (such as voice mail), and information services did not adversely affect competition and further found that structural separation requirements were not necessary to preserve competition. When ILECs are efficient suppliers and their participation does not harm competition, restricting ILECs as competitors by subjecting them to dominant carrier regulation would only adversely affect competition.

50. AT&T's general condemnation of ILEC provision of non-local services also ignores the variety of other regulatory safeguards in place. As discussed in our prior declaration, ILECs have long been subject to nondiscrimination requirements in their provision of access services, and they have developed systems, procedures and processes to ensure that they comply with their nondiscrimination obligations. They also face established, sophisticated long-distance competitors who presumably monitor the quality of the access services they receive. The

29. AT&T Comments, p. 18.

elimination of structural separation will not alter these realities, nor would dominant firm regulation address any perceived risk of increased discrimination. Nor, for that matter, does AT&T explain how ILECs could keep rivals from the market if they attempted to raise long-distance price and thus recoup investments in a predatory price squeeze. AT&T also fails to explain how ILECs would benefit from shifting costs from unregulated to regulated activities given the widespread reliance on price-cap regulation and establishment of interstate access fees based on factors other than ILECs' costs (through the CALLS order).

51. Thus, there is no basis for AT&T's suggestion that ILECs' provision of non-local services is inherently anticompetitive. Rather, the heightened competition in long-distance services that has resulted from BOC entry, experience in other markets that BOCs have been permitted to enter, such as CPE and enhanced services, and price regulation, where necessary, of access and local services provide ample evidence that ILECs' provision of non-local services benefits consumers and promotes competition.

B. DR. SELWYN INCORRECTLY SUGGESTS THAT STRUCTURAL SEPARATION REQUIRES THAT ILECS BE DENIED ANY ADVANTAGES OF VERTICAL INTEGRATION. HOWEVER, RESTRICTIONS ON ILEC ACTIVITIES CAN REDUCE THEIR EFFECTIVENESS AS SUPPLIERS OF NON-LOCAL SERVICES AND HARM CONSUMERS

52. Dr. Selwyn claims that the separate subsidiary requirements of Section 272 require affiliates to ignore any efficiencies from their affiliation with a BOC.[30] He claims that:

> [L]ower long distance prices arising solely or primarily from BOC exploitation of integration efficiencies and joint profit maximization is clearly not what Congress had in mind. … If the BOCs are the *only* downstream providers that are permitted

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30. Selwyn states that Section 272 reflects "an attempt to force the affiliate (the provider of the downstream product) to set its retail prices so as to maximize its own profits, just as any non-affiliated IXC, which is operating in the (same) downstream product market, would be expected to do." (Selwyn Declaration, p. 62)

> to benefit from these types of integration efficiencies, then they will ultimately be the only downstream providers to survive in the retail long distance mass market. And that outcome is clearly *not* what Congress intended, and will surely result in less competition and higher prices overall.[31]

53. Dr. Selwyn's fear that ILECs will displace all other long-distance carriers appears to be based on his failure to consider the costs ILECs face in terms of foregone access revenue in providing long-distance services. When these costs are properly considered, there is no reason to conclude that ILECs' provision of local services gives them any inherent access cost advantage that would enable them to supplant all other competitors. The history of ILEC provision of long-distance services to date fails to support Dr. Selwyn's proposition.

54. While we offer no opinion on Congress' intent in drafting Section 272 of the 1996 Act, Dr. Selwyn's interpretation would be expected to result in significant consumer harm. As noted above, market activities by CLECs as well as ILECs indicate that many consumers prefer obtaining local and long-distance services from the same supplier. That is, it often is economically efficient to provide these services jointly. Dr. Selwyn's interpretation would surely interfere with ILECs' ability to exploit these and other potential efficiencies that ILECs could realize by integrating their local and long-distance operations.

VI. CONCLUSION

55. ILECs have no ability to engage in non-price discrimination against rival long-distance carriers, a predatory price squeeze against long-distance rivals or cost shifting that adversely affects long-distance competition, whether or not they offer long-distance services through a separate affiliate. Accordingly, there is no basis for imposing dominant carrier regulation on the ILECs' provision of in-region, interstate, interLATA services.

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31. Selwyn Declaration, p.63.

I declare under penalty of perjury that the foregoing is true and correct to the best of our knowledge and belief.

Dennis W. Carlton

Dennis W. Carlton

Hal Sider

Hal Sider

Allan Shampine

July 28, 2003