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October 21, 2005

Via ECFS

Ms. Marlene Dortch
Secretary
Federal Communications Commission
The Portals
445 12th Street, SW
Room TWB-204
Washington, DC 20554

Re: Notice of Ex Parte Presentation --
DA 05-656, WC Docket No. 05-65 and
DA 05-762, WC Docket No. 05-75

Dear Ms. Dortch:

XO Communications, Inc. ("XO") hereby submits this ex parte letter addressing a crucial issue raised in the SBC-AT&T and Verizon-MCI mega-merger dockets, WC Dockets Nos. 05-65 and 05-75: will new entry post-merger fully offset the competitive harms to customers in the local wholesale market caused by the proposed mergers of SBC-AT&T and Verizon-MCI? XO is including as part of this letter the attached Declaration of Wil Tirado, Director of Transport Architecture for XO, which was filed on October 1, 2004 in WC Docket No. 04-313 and CC Docket No. 01-338. Mr. Tirado discusses from an engineer's perspective the many barriers to the development of new local loop and transport facilities and the fact that ***"constructing facilities based 'on spec,' where customer demand is not assured, is an unsustainable business proposition."*** This is "especially true now, as the capital markets are simply 'closed' to supporting facilities construction where efficient near-term use is not clearly demonstrated."

As a complement to Mr. Tirado's Declaration, and to dispel the argument that new entry will cure the competitive harms caused by the proposed mergers of SBC-AT&T and Verizon-MCI, this letter reviews these entry issues into wholesale local access markets from an antitrust perspective. It also rebuts the fallacious arguments of the SBC and Verizon that local fiber plant and fiber-based collocations are good indicia of post-merger entry.

The Horizontal Merger Guidelines ("Guidelines") set forth the methodology used by the U.S. Department of Justice and the Federal Trade Commission to conduct the required economic and legal analysis of the competitive effects of proposed mergers.[1] Of central concern in such analysis is ability of a firm or group of firms to exercise "market power" after the consummation of a merger, and the Guidelines discuss the importance of entry as a means to defeat the exercise of market power. The Guidelines discuss how such entry must be "easy," which is determined by its timeliness, likelihood, and sufficiency.

> Entry that is easy if entry would be ***timely, likely, and sufficient*** in its magnitude, character and scope to deter or counteract the competitive effects of concern. In markets where entry is that easy (i.e., where entry passes these tests of timeliness, likelihood, and sufficiency), the merger raises no antitrust concern and ordinarily requires no further analysis.[2]

According to the Guidelines, entry that is timely must be "achieved within two years from initial planning to significant market impact."[3] According to the Guidelines, ***entry that occurs more than two years after a consummated merger cannot deter or counteract the competitive effects of concern, namely the exercise of market power.*** Moreover, the Guidelines note that entry must be "***committed***," which is defined as "new competition that requires expenditure of significant sunk costs of entry and exit."[4] Thus, it is critical for the Federal Communications Commission ("Commission") to determine with precision the timing, likelihood and sufficiency of post-merger entry. Vague generalities will not suffice.[5] Even if the Commission believes that over a much longer term entry will recreate pre-merger conditions, entry that replicates pre-merger conditions ***outside the two year window*** is considered insufficient to alleviate harms to customers.

In addition to Mr. Tirado's Declaration, as discussed below, AT&T's own submissions and presentations to the Commission in the Triennial Review proceedings demonstrate that entry or expansion by competitive local exchange carriers ("CLECs")

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[1] Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission, Revised April 8, 1997.

[2] Id. § 3.0 (emphasis added).

[3] Id. § 3.2.

[4] Id. at 26 (emphasis added).

[5] The Commission has a record of rejecting use of such vague indicia of potential competition. *See*, for instance, *In the Matter of Unbundled Access to Network Elements* (WC Docket 04-313), *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* ("Triennial Review Remand Order" ("TRRO")) (CC Docket No. 01-338), Order on Remand, FCC 04-290, (rel. February 4, 2005), ¶110.

will not be timely, likely, or sufficient because the prohibitive costs of such entry or expansion.[6]

High Costs as a Barrier to Timely Entry

As generally recognized, high costs, in particular high fixed costs, considerably reduce the ease of entry and expansion. These costs also decrease the chances that entry will be timely by Guideline standards. AT&T's submissions and presentations to the Commission highlight the high costs of entry and expansion, as well as the cost advantages enjoyed by incumbent local exchange carriers ("ILECs"):

> Thus, as the Commission has recognized, there will be severe short run asymmetries between the incumbent and a competitor that make it very difficult, if not impossible in many instances, for new entrant competitive carriers to deploy bypass transmission facilities.[7]
>
> The record here (*e.g.*, D'Apolito/Stanley Dec.) similarly supports the conclusion that facility construction remain very high – generally $125,000 per mile, and often multiples of that costs, especially in dense commercial areas of large cities.[8]
>
> Thus, the new entrant's cost of constructing a loop to serve a new customer in a new building is easily in the range of $91,000 compared to the incumbent's zero incremental investment (in most cases) or an investment *less than half* that of competitor's in the minority of cases where additional lines might be required.[9]

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[6] "AT&T Presentation to the FCC Comparing ILEC and CLEC Network Architectures" ("AT&T Presentation"), October 3, 2002, filed in CC Docket 01-338. "Transport UNEs Are a Prerequisite for the Development of Facilities-Based Local Competition" ("Transport UNEs"), AT&T Presentation, October 7, 2002, filed in CC Docket 01-338. "Letter from Joan Marsh, Director, Federal Government Affairs, AT&T, to Ms. Marlene Dortch, Secretary, Federal Communications Commission" ("Marsh Letter"), November 25, 2002, filed in CC Dockets 01-338, 96-98 and 98-147. "Reply Declaration of Anthony Fea on Behalf of AT&T Corp." ("Fea Declaration"), October 18, 2004, filed in WC Docket 04-313 and CC Docket 01-338. It should be noted that MCI made similar filings in the Triennial Review proceedings. *See*, for instance, MCI's Comments and Reply Comments in WC Docket No. 04-313, October 4, 2004 and October 19, 2004.

[7] Fea Declaration at 12.

[8] Id. at 5.

[9] Id. at 20.

> Thus, the incremental cost of the transport route capacity . . . is $1.85 million for the new entrant, compared to $40,000 for the incumbent – a 46-fold advantage.[10]

> CLEC cost disadvantages in constructing transport can be greater than 200%.[11]

> Access to unbundled elements at TELRIC rates is also critical as a protection against the incumbent's ability to use its enormous short-run cost advantages to deter entry.[12]

> All the ILEC attacks on UNEs (and combinations) are premised on the absurd notion the CLECs are NOT impaired in their efforts to cost-effectively deploy the functional equivalent of a ILEC cross-connect.[13]

In general, high fixed costs act as barriers to entry. As AT&T's submissions and presentation indicate, a majority of the costs associated with entry or expansion into local access markets is fixed.

> Moreover, nearly two-thirds of interoffice transport costs are fixed.[14]

> At every point of demand aggregation the majority of the costs are fixed for a relatively large demand set.[15]

> The huge fixed costs of facility-based collocations require a means to aggregate demand that does not require building at every LSO.[16]

In a previous proceeding, AT&T's own economic witness stressed to the Commission the fact that the requirement of large fixed or sunk costs makes new entry risky and unlikely. As explained by Professor Robert D. Willig in 2002 in the FCC's inquiry into ILEC unbundling obligations:

> where entry involves sunk costs, it is rational for the incumbent to respond to new entry by pricing all the way down to its short run marginal cost,

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[10] Id. at 25.

[11] Transport UNEs at 5.

[12] Fea Declaration at 31.

[13] AT&T Presentation.

[14] Marsh Letter at 2.

[15] AT&T Presentation.

[16] Id.

> which (because of the existence of sunk costs) is likely below the incumbent's (and the entrant's) average cost. The rational prospect that the incumbent will do this makes it less likely that an entrant can be profitable, and its entry will thus be deterred. This is particularly true where the incumbent serves virtually the entire market and the new entrant must convince substantial numbers of customers to switch from the incumbent in order to achieve economic viability.[17]

Specifically discussing this issue with regard to investment in both local loops and interoffice transport, Professor Willig also noted that this disincentive against entry is likely to be magnified, since sunk costs are often largely fixed as well.[18] As he explained to the Commission on behalf of AT&T:

> Where scale economies exist, in order for an entrant to achieve a cost structure comparable to the incumbent, the entrant must deploy substantial capacity. But entry on such a massive scale will flood the market with excess capacity, making it unlikely that the entrant will be able to sell services at a price that will allow it to recover its sunk investment. Knowing this to be the case *ex ante*, the entrant will be deterred from entering and sinking its costs.[19]

Excess Capacity

When considering entry into local wholesale access markets, it is important to recognize that the mergers as proposed to the Commission will leave in place AT&T's and MCI's substantial local network assets under the ownership of post-merger SBC and Verizon. Any firm contemplating entry into these markets must take into account the effect that such capacity likely would have on post-entry prices. The capacity held by the post-merger SBC and Verizon enables them to credibly threaten an entrant with low post-entry prices, which in turn facilitates their ability to prevent such entry and maintain high prices. AT&T's submissions and presentations acknowledge these facts.

> ILEC networks thus have substantial excess capacity and can be expanded without need for new construction[20]

[17] Robert D. Willig, *Determining "Impairment" Using the Horizontal Merger Guidelines Entry Analysis*, attached to Ex Parte Letter from C. Frederick Beckner, III, Sidley Austin Brown & Wood LLP, to Marlene H. Dortch, Secretary, Federal Communications Commission, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Dkt No. 01-338 (F.C.C. Nov. 14, 2002), at 3-4 ("Willig White Paper").

[18] *See* Willig White Paper at 4, 13.

[19] Willig White Paper at 4.

[20] Transport UNEs at 5.

> The evidence already before the Commission demonstrates that a competitive carrier almost never has in place all of the facilities it will need to respond to an enterprise customer's requirements.[21]
>
> The new entrant recognizes that when it deploys this sunk plant, it must recover its incremental costs within the span of a typical customer contract – generally three years.[22]

According to the most recent data published by the FCC, for example, the RBOCs had collectively deployed 43.9 million kilometers of fiber in cable throughout the U.S. as of December 31, 2003. This total includes both lit and dark fiber, however. Counting just lit fiber, the RBOCs had collectively equipped approximately 14.6 million kilometers as of year-end 2003, implying that approximately two-thirds of the fiber in cable deployed to date by the companies is currently dark.[23] In other words, excess fiber capacity within the RBOCs' networks is roughly twice the capacity that the firms have equipped and lit.

Not only is there substantial excess capacity in local fiber networks already, but this glut is ever increasing as compression technologies increase the capacity of existing lit fiber more rapidly than network traffic grows. ***In such an environment, it is highly doubtful that new facilities-based entry would occur, as entrants would be loath to commit to new fiber investment in the face of a large and growing excess of capacity.***

Again, ***Professor Willig has argued this same proposition*** before the Commission on behalf of AT&T previously, noting that the Horizontal Merger Guidelines "find lower sales opportunities where the incumbent has made sunk investment in capacity that is capable of serving both existing and foreseeable market demand."[24] According to the AT&T witness, entry requiring sizeable investment is unlikely "where the market has a low growth rate or where incumbent providers have substantial excess capacity that is sunk."[25]

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[21] Fea Declaration at 13.

[22] Id. at 21.

[23] Federal Communications Commission, *Statistics of Communications Common Carriers* (2003/2004 ed.), at Table 2.6.

[24] Willig White Paper at 6.

[25] Willig White Paper at 6.

SBC and Verzion Proposed Surrogate Benchmarks for Determining Entry Post-Mergers are Inadequate

SBC and Verizon argue that competitive providers other than AT&T and MCI will rapidly fill the competitive void post-merger because these other competitive providers have either already constructed substantial fiber or have numerous fiber-based collocations in the local markets and will use these as a basis to build out rapidly, thereby alleviating the competitive harms. To any economist, this is nonsense. To any competitive provider, this is absurd.

First, these two possible indicia for entry cannot carry any weight in an antitrust context because all they indicate are the ***current presence*** of competitive providers on ***select routes – not the timing, likelihood, and sufficiency of construction of new plant throughout a market to replicate the competitive presence of AT&T and MCI. No competitive provider constructs infrastructure today using a "build it and they will come" strategy. That approach was abandoned during the industry crash five years ago. Today, capital expenditures are all "success-based."*** As set forth in the Tirado Declaration and AT&T filings, competitive providers first get the customer, then build where the volumes are sufficient to overcome the enormous entry barriers. This is a highly selective, laborious, and time-consuming process. Local telecommunications providers and their investors just lived through a gold rush that wiped out many companies and wasted many hundreds of billions of dollars. No one wants to repeat this.

Second, all providers build based on price signals in the market. In their letter dated August 12, 2005, SBC and AT&T assert that competitive carriers have more collocation arrangements in SBC wire centers than does AT&T and that CLECs therefore "could readily replace AT&T and are not dependent on AT&T or AT&T's collocation arrangements."[26] The letter further argues that "CLECs have the same (or greater) ability as AT&T economically to serve any remaining buildings (including any building that AT&T serves using leased facilities) by connecting special access circuits (or UNEs) to their metropolitan fiber via fiber-based collocation and providing so-called 'partial Type II' service."[27] Unfortunately, this cavalier, "let them eat cake" attitude has proven a failure in the real world. AT&T, MCI, and others have already placed in the record in this and other Commission proceedings the fact that SBC and Verizon special access rates produce supranormal profits and that these rates are increasing. Similarly, as Uri and Zimmerman (2004) have documented in their extensive and detailed empirical analysis, ILEC special access rates have increased substantially since they were

[26] Letter from Gary L. Phillips on behalf of SBC to Marlene H. Dortch, Secretary, FCC ("Phillips Letter"), August 12, 2005, Re: DA 05-656, WC Docket No. 05-06 and DA 05-762, WC Docket No. 05-75.

[27] Id.

deregulated.[28] If entry were indeed as easy as is asserted by SBC and AT&T, such price increases would have been eliminated by CLEC entry into local wholesale access markets. Moreover, as the econometric analysis of granular CLEC bid data performed by Dr. Simon J. Wilkie demonstrates, ILEC special access rates substantially decline in a statistically significant manner when CLECs offer service on a given loop or transport circuit. Again, if entry were as easy as postulated by SBC and AT&T, this statistical relationship between CLEC presence and SBC's special access rates would not exist. If such high prices – and such large differences between the ILEC special access rate and the prices offered by competing carriers – were not sufficient to stimulate local entry already, there is no reason to believe that it will occur after the proposed mergers are consummated.

Third, ***competitive providers have placed in the record documentation and analyses of data bases of local wholesale market offers by competitive provider.***[29] These were filed pursuant to Civil Investigative Demand at the Department of Justice and have been sworn to as authentic and complete. ***These data bases demonstrate that AT&T and MCI are by far the two most frequent bidders to provide local circuits at the wholesale level.*** Other competitive providers – those who SBC and Verizon allege already have fiber in the ground and are collocated – infrequently participate. If they do not take advantage of these sales opportunities today, there is no reason to believe they will post-merger.

Fourth, ***the local fiber maps placed in the record of these proceedings by SBC and Verizon previously were rejected as not useful by the Commission in the TRRO***:

> These data [on local route miles, lists of fiber wholesalers (without route-based analysis) and counts of CLEC Networks] are not complete, not representative of the entire industry, not readily comfirmable, and aggregated at too high a level to be informative of local market conditions."[30]
>
> [T]he value of these [local fiber] maps to our analysis is undermined by several shortcomings. Among other things, they fail to indicate the capacity of service being provided over the facilities described, or whether

[28] Noel Uri and Paul Zimmerman (2004), "Market Power and the Deregulation of Special Access Service by the Federal Communications Commission," *Information & Communications Technology Law*, vol. 13, no. 2, pp. 129-173.

[29] Notice of Ex Parte Presentation and Attachment from Thomas W. Cohen on behalf of Conversent Communications, Eschelon Telecom, NuVox Communicaitons, XO Communications and Xspedius Communications to Marlene H. Dortch, Secretary, Federal Communications Commission filed as CONFIDENTIAL INFORMATION SUBJECT TO THE PROTECTIVE ORDER IN DOCKETS NOS. 05-65 & 05-75 BEFORE THE FEDERAL COMMUNICATIONS COMMISSION, October 3, 2005.

[30] TRRO at ¶110.

> those facilities are in fact being used to provide services for which competitive LECs may use UNEs."[31]

As further evidence supporting the Commission's conclusion that these maps have no real value, XO examined the list of fiber providers in the Los Angeles market as provided by SBC and found that 50% of them have no state CLEC certification.

Fifth, in addition to the flaws discussed above with the fiber-based collocation approach, SBC's claims about the number of fiber-based collocators in its markets are inaccurate and misleading. In an August 12, 2005 ex parte, SBC contended that there are "more than 1,700 non-AT&T collocation arrangements" in its wire centers.[32] This list, however, counts "collocation *arrangements*," not fiber-based collocators. In fact, the list double counts multiple collocations by the same entity, and, in the case of XO, double counts collocations established by XO and Allegiance Telecom in the same wire center.[33] Further, the Michigan Public Service Commission just one month ago issued an Order that SBC had incorrectly "delisted" the Dearborn Fairborn wire center, finding among other deficiencies that SBC had counted cross-connects as fiber-based collocations:

> The Commission agrees with Covad, the Joint CLECs, and the Staff that SBC failed to meet its burden to demonstrate that there are at least four fiber-based collocators at the Dearborn Fairborn wire center. The arrangement in which one CLEC cross connects to the facilities of another CLEC that is a fiber-based collocator does not increase the number of fiber-based collocators for purposes of this analysis.[34]

Consequently, the entire collocation analysis placed in the record by SBC on August 12, 2005, is suspect, and the conclusions as to the presence of AT&T and other competitive providers should be given no credence.

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[31] Id. at n. 445.

[32] Phillips Letter.

[33] In addition to these problems with the Phillips Letter, there are a host of problems with the statistical analysis in the letter, including the failure to examine relevant markets (e.g. the local market) and the use of the novel, but largely inapt, statistics about the relationship between collocations and distances between wire centers. Further, non-AT&T competitive entry is very concentrated. For example, in California, based on SBC's February 18, 2005 wire center list, only 41 wire centers were listed as having 3 or more non-AT&T collocators. Even this number overstates the actual number of collocators, given the errors in SBC's identification of fiber-based collocators, as described above.

[34] *In the matter, on the Commission's own motion, to commence a collaborative proceeding to monitor and facilitate implementation of Accessible Letters issued by SBC MICHIGAN and VERIZON*, Case No. U-14447, ORDER, September 20, 2005, p.11.

Conclusion

In sum, because of the presence of substantial barriers to entry in wholesale local access markets, post-merger entry into these markets will not be timely, likely, or sufficient to deter or counteract the likely anticompetitive effects of the proposed mergers. It is therefore incumbent upon the Commission to reject these mergers unless it determines and adopts remedies to alleviate the demonstrated harms to the local wholesale markets.

Sincerely,

Thomas Cohen

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Counsel to XO Communications

Attachment: Declaration of Wil Tirado on Behalf of XO Communications, Inc.

cc: Daniel Gonzalez
Michelle Carey
Russ Hanser
Jessica Rosenworcel
Scott Bergmann
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Thomas Navin
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Julie Veach
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