Even if the Commission were to decide to regulate IP/packetized services, it could not easily apply its experience in regulating traditional TDM-based services to limit ILEC opportunities to discriminate. As the Commission has held, "With the increased network complexity, the possibility for new types of discrimination, comes also an increased difficulty in detecting discrimination. In such a situation, past experience with the interconnection of ... POTS service, becomes increasingly less useful as a regulatory tool for preventing detecting, and remedying discrimination." *SBC/Ameritech Order* ¶ 220. For example, not only are there no regulations or standards with regard to class of service ("CoS") and ("QoS") for the exchange of IP-VPN service, but even if there were, the Commission has had no experience implementing and enforcing such regulations. The inability of the FCC to "foresee every possible type of discrimination, especially with evolving technologies," *id.* ¶ 206, makes "reliance on existing regulatory safeguards misplaced," *id.*

Even with regard to traditional TDM-based services, the Commission has been largely unable to prevent ILEC discrimination after the implementation of Sections 251 and 271. The Applicants would have the Commission believe that any discrimination under Sections 251 and 271 would be policed by "self executing remedy plans," that would "kick-in" if the Applicants acted in a discriminatory fashion. *See Public Interest Statement* at 118. The Applicants argue further that the absence of penalty payments is evidence that no discrimination is occurring. This is simply not the case. For example, as recent TWTC testimony before the Tennessee Regulatory Authority demonstrates (1) many state Commissions do not have adequate remedies for poor and discriminatory performance; and (2) in such a regulatory vacuum, RBOCs (AT&T, in particular) continue to discriminate against carriers such as TWTC with respect to TDM-based services.[67] Moreover, the ILECs have repeatedly and effectively prevented competitors from obtaining UNEs on reasonable terms and conditions. Their most effective strategy has been litigation. The ILECs challenge virtually every unbundling order. Just last month, almost ten years after the passage of the 1996 Act, the D.C. Circuit heard another round of oral arguments in an ILEC appeal of the Commission's unbundling rules. The resulting legal uncertainty is one of the reasons TWTC has relied almost exclusively on special access.

The ILECs have also relied effectively on simple refusals to deal to prevent reliance on UNEs. For example, relying on claims of no "facilities available," the "incumbent LECs sometimes do not permit competitors to obtain new circuits as UNEs, and only permit the competitive LEC to convert facilities obtained as special access to UNEs after a 'holding period' of one to several months." *TRRO* ¶ 64. Moreover, "Verizon sometimes imposes large, nonrecurring charges on UNEs that are not imposed on special access." *Id.* n.183 (internal citations omitted). BellSouth and AT&T (SBC) have engaged in similar tactics.[68] For these reasons, the Commission determined that many carriers purchase special access because ILECs refused to offer UNEs in a non-discriminatory fashion. It is clear therefore that the absence of penalties under state performance plans does not demonstrate the absence of ILEC price and non-price discrimination in the provision of traditional TDM-based services.

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[67] See Direct Testimony of Lionor M. Torrez on behalf of TWTC, filed in Tennessee Regulatory Authority Docket No. 06-00093 (June 2, 2006) at 3-7.

[68] *See, e.g,* Declaration of James C. Falvey on Behalf of Xspedius Communications ¶ 38, attached to Comments of Loop and Transport CLEC Coalition, WC Dkt. No. 04-313 *et al.* (Oct. 4, 2004) ("Xspedius has recently experienced a significant increase in the number of UNE orders rejected by SBC Texas because there were 'no facilities' available, and it would ostensibly require more than 'routine network modifications.' Yet, when ordered as Special Access, the same circuits are provisioned with alacrity."); *id.* ¶ 39 (noting that, when Xspedius attempted to convert a special access circuit to a UNE circuit, BellSouth charged Xspedius an $800 per circuit non-recurring charge).

Finally, contrary to the Applicants' assertion, their incentive to discriminate is not eliminated or even reduced after Section 271 approval has been granted. The Applicants quote paragraph 242 of the *SBC/Ameritech Order* to argue that, after SBC and Ameritech received 271 authority, "their ability to discriminate successfully against rival local service providers should diminish." This is flatly incorrect. To begin with, as the FCC observed in footnote 453 (following the very sentence quoted by the Applicants), the grant of Section 271 authority will *create* incentives to discriminate against interexchange carriers. The proposed merger will increase this incentive because more traffic will both originate and terminate in the merged company's territory, allowing the internalization of external effects. *See Bell Atlantic/GTE Order* n.429. In addition, the Commission based its quoted prediction of non-discrimination on SBC's fulfillment of its "national-local strategy," which it never undertook. Moreover, the Commission concludes in that same paragraph that "[e]ven after receiving section 271 authority, the threat of discrimination remains in force." *SBC/Ameritech Order* ¶ 242.

B. Discrimination Practiced In One Region Creates "Spillover" Effects In Other Regions.

As the Commission has found, discrimination practiced in one region affects competition in other regions.[69] Especially for potential entrants planning to compete at a sufficiently large scale in numerous major markets (*e.g.*, national competitors such as Time Warner Telecom), the discrimination practiced by the incumbent in one region or one local market may impair the ability of entrants to compete in a broader geographic area.

These "spillover" effects are heightened because competitive entry into a new market outside of the discriminating ILEC's region entails common research, product development, and

[69] *See SBC/Ameritech Order* ¶ 192 ("In many cases, discriminatory conduct by an incumbent LEC in its region affects a competitor in areas both inside and outside the incumbent's region.").

marketing costs that must be funded by the competitor's profits both inside and outside of that ILEC's region.[70] Discrimination against multi-region competitors (and competitors planning to expand their networks out-of-region) reduces profitability and therefore likelihood of entry into new regions.

Discrimination practiced by an ILEC in its region therefore creates anticompetitive spillover benefits for other ILECs dominant in other regions which are not captured by the discriminating ILEC. When an ILEC engages in discrimination, it cannot capture the full benefits of its discrimination because its misconduct raises its rivals' costs both inside and outside its region. However, a merger between the discriminating ILEC and another ILEC internalizes this externality by capturing the spillover effect within the merged company. In its *SBC/Ameritech Order*, the Commission explained how this spillover effect works in practice:

> [I]f SBC discriminates against a competitive LEC attempting to enter Houston, it will raise this rival's costs. This competitive LEC will have less capital to spend on common research, product development, and marketing costs, making the competitive LEC a less effective competitor in other areas such as Chicago because of its overall higher costs. Prior to the merger, SBC would not realize the benefits in Chicago from such conduct. After merging with Ameritech, which is the incumbent LEC in Chicago, SBC would realize such benefits. Because SBC after the merger would realize more of the gains from what are presently "external" effects, it would have a greater incentive to engage in discrimination than the combined incentives that the two individual companies would have had in their smaller regions.[71]

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[70] *See id.* ("Spillover effects indirectly affect customers when an incumbent LEC's discrimination in one region increases a national rival's general costs, thereby indirectly impairing the ability of this rival to provide service to customers in other regions. For instance, a competitive LEC's entry into various areas usually entails fixed costs such as research, product development, and marketing costs that must be covered by the sum of the competitive LEC's area-specific profits. If SBC raises this competitive LEC's costs in Houston, less money is available to cover these fixed costs, and it is likely to become a less effective competitor in other areas such as Chicago, or it may forego entry into the Chicago market altogether.").

[71] *Id.* ¶ 60. The seminal Supreme Court case on monopoly leveraging fifty years ago specifically alluded to the dangers of increasing the number of local monopolies held by a firm bent on leveraging its power:

The larger is an ILEC's footprint, the more fully it is able to appropriate the gains from discrimination and the greater, therefore, is its incentive to discriminate. A merger that results in an ILEC with a large footprint increases the rewards from discrimination and thus makes such discrimination more likely.[72]

The proposed merger will result in precisely this harm because of the unprecedented size of the merged entity. The FCC previously held that the merger of Bell Atlantic and GTE would cause substantial harms due to the increased incentives and opportunity for discrimination when the combined company served approximately one-third of access lines nationwide. *See Bell Atlantic/GTE Order* ¶ 160. The present merger will create an even larger footprint and therefore the potential for even more serious harms. Based on company data and the most recent FCC wireline statistical reports, a combined AT&T/BellSouth will serve 40.29 percent of the nations access lines, Verizon will serve 28.45 percent, while Qwest will only serve 8.47 percent. *See RBOC Market Share Chart.* The relative revenues tell a similar story, with Verizon at $75.11 billion, a combined AT&T/BellSouth at $98.84 billion, while Qwest will only have $13.9 billion. *See id.*

The Applicants rather lamely suggest that, because they already compete out of region, their incentives to discriminate are unchanged by the merger. *See Public Interest Statement* at

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> A man with a monopoly of theaters in any one town commands the entrance for all films into that area. If he uses that strategic position to acquire exclusive privileges in a town where he has competitors, he is employing his monopoly power as a trade weapon against his competitors. It may be a feeble, ineffective weapon where he has only one closed or monopoly town. But as those towns increase in number throughout a region, his monopoly power in them may be used with crushing effect on competitors in other places.

United States v. Griffith, 334 U.S. 100, 107 (1948) (Douglas, J.) (emphasis added).

[72] *See SBC/Ameritech Order* ¶ 196.

119-20. Although a substantial public interest harm will result if AT&T's out-of-region special access facilities in BellSouth's region are eliminated through the merger, AT&T's existing network footprint and customer base in BellSouth's region pales in comparison to BellSouth's ILEC network footprint and customer base. The expansion of AT&T's network and customer base through merger with BellSouth in the BellSouth region would therefore be enormous, as would the corresponding increase in its incentive to discriminate.

C. The Merged ILEC's Increased Incentives And Opportunities For Discrimination Threaten Competition For Established And Newly Developing Advanced Services.

As discussed, both AT&T and BellSouth have acted on their incentives in the past to raise TWTC's and other competitors' costs in providing now-well established services to business customers such as DS1 and DS3 connectivity with voice and Internet access.[73] The proposed merger threatens to increase instances of this type of conduct.

The threat posed by the merged entity's increased incentive to deny, delay, degrade or overprice inputs needed by competitors is even more threatening to the competitive provision of newly IP-based emerging services. TWTC's experience in attempting to obtain the inputs it needs to provide Ethernet services to business customers illustrates precisely the risk associated with the expanded ILEC footprint that the merged entity would acquire.

As explained in the attached declaration of Graham Taylor, TWTC's Senior Vice President for Marketing, business customers increasingly demand Ethernet because it permits customers to experience significant cost savings and improved service quality as compared to TDM-based services. *See Taylor Decl.* ¶¶ 7-12. In developing Ethernet service, TWTC has

[73] For example, as described in more detail below, AT&T refuses to put into place meaningful performance metrics provisions into its traditional special access agreements.

incurred substantial fixed costs to purchase equipment and implement back office systems and to train personnel to manage the service. *See id.* ¶ 17. TWTC has also incurred substantial costs that remain fixed until TWTC enters a new geographic area, such as the purchase and installation of Ethernet switches, multiplexers, routers and collocation space. *See id.* ¶ 18. In order to recover these costs, TWTC has sought to offer Ethernet in as many geographic areas as possible. *See id.* ¶ 17.

In order to do so, TWTC must be able to lease ILEC Ethernet loops serving locations in which TWTC cannot efficiently deploy its own facilities. As Mr. Taylor explains, it is substantially more efficient for TWTC to use ILEC Ethernet loops than to rely on ILEC DS1 or DS3 loops to which TWTC attaches Ethernet equipment. *See id.* ¶ 26 Accordingly, TWTC has entered into discussions with ILECs to obtain Ethernet loops.

Unfortunately, there are no stable regulatory arrangements established for access to Ethernet local transmission facilities. TWTC has been negotiating for over a year to obtain reasonable rates for Ethernet services, without success. As Mr. Taylor explains, **[proprietary begin]**

[proprietary end][74] TWTC cannot possibly compete by relying Ethernet under the prices, terms and conditions offered by AT&T.

AT&T's anticompetitive exclusionary conduct with regard to Ethernet loops sought by TWTC is highly significant for purposes of the instant merger. AT&T's conduct would likely only worsen post merger. Moreover, AT&T's more aggressive approach is likely to spread to the BellSouth region. For example, **[proprietary begin]**

[proprietary end] Given its smaller footprint, it is not surprising that BellSouth is more cooperative with wholesalers than is AT&T. If BellSouth were to become part of an ILEC with a much larger footprint, it would likely cease even the few cooperative practices in which it engages now.

There can be little question that a merged AT&T-BellSouth could appropriate more of the gains from discrimination than either ILEC can today. For example, approximately

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[74] It is important to emphasize that the availability of TWTC as a benchmark for AT&T's conduct in this case is highly unusual. The much more common situation is that only ILECs are available as benchmarks for other ILECs' conduct.

[proprietary begin]

[proprietary end] If BellSouth today were to discriminate against TWTC in the provision of an input needed to serve such customers, BellSouth would only appropriate the benefits of such discrimination in the BellSouth region. However, a merged AT&T-BellSouth would appropriate the benefits of such discrimination in both the BellSouth and AT&T regions. Thus, the merged entity will have a greater incentive to discriminate.

Moreover, the opportunities to appropriate gains from discrimination in both the BellSouth and AT&T regions are likely to increase. As explained, business customers increasingly demand that their service providers take advantage of the efficiencies of IP technology to provide data service to all of the customer's locations. Thus, while TWTC has in the past been able to offer Ethernet to a limited subset of a customer's locations, some of which were large enough to enable TWTC to construct its own loops facilities, now TWTC must be able to serve all or almost all of a customer's locations. *See id.* ¶ 25. Since TWTC cannot deploy loops to most of the customer locations that it will now need to serve, the change in customer demands for IP services will require that TWTC acquire ILEC loops serving more locations than in the past. Given that the average TWTC customer has **[proprietary begin]**

[proprietary end] it is clear that TWTC must increase substantially the number of locations it must serve per customer in order to meet changing customer demands. In fact, TWTC's customers currently have **[proprietary begin]**

[proprietary end] in areas where

TWTC does not have any fiber deployed at all. *See id.* ¶ 21. TWTC would need to serve all of those locations today exclusively via ILEC local transmission facilities. Again, a merged BellSouth-AT&T is even more likely to deny, delay, degrade and overprice those inputs than is the case today.

The development of IP-based services will offer the merged firm numerous other opportunities for discrimination in the future. For example, for TWTC to offer efficient and reliable Ethernet and VPN service, it must ensure that IP traffic, including IP voice traffic, carried on ILEC Ethernet and VPN facilities, is subject to appropriate CoS and QoS requirements. *See id.* ¶¶ 28-30. Absent such requirements, voice packets that require priority treatment and that cannot tolerate latency will not receive the treatment they require. As Mr. Taylor explains, **[proprietary begin]**

[proprietary end]. Such discrimination permits AT&T to capture a larger portion of the IP-VPN and Ethernet retail markets. This is exactly the type of discrimination that would be expected from a carrier with market power and that will increase if the merger is approved.

V. THE MERGER WILL REDUCE REGULATORS' ABILITY TO DETECT AND PUNISH ILEC ANTICOMPETITIVE CONDUCT.

Competition in the provision of downstream retail services is only possible if regulators limit AT&T's and BellSouth's opportunities to overprice, deny, delay and degrade competitors' access to necessary inputs. Perhaps the most effective means of regulating ILEC conduct is to "benchmark" the behavior of one ILEC against another. As the FCC explained in the *SBC/Ameritech Order*,

> Given [their] incentives to resist competitive entry, independent incumbent LECs, absent collusion, are likely to adopt different defensive strategies to forestall competitive entry, and each particular strategy will reveal information to regulators and competitors. One incumbent LEC may claim, for example, that a particular form of interconnection is infeasible, while a second may resist the unbundling of a particular network element, and a third may oppose the collocation of specific types of equipment within central offices. In such situations, the behavior of other major incumbent LECs can be used as benchmarks to evaluate the outlying incumbent's claims.

SBC/Ameritech Order ¶ 108. Without the ability to benchmark the performance and behavior of one RBOC against another, the FCC and the state commissions "would very likely have to engage in highly intrusive and consuming regulatory practices, such as investigating the challenged conduct directly and at substantial cost ...." *Bell Atlantic/GTE Order* ¶ 133.

As the Commission has recognized, the importance of comparative benchmarking will only increase in the future as BOCs and CLECs begin to provide new technologies and services based on packet-switched technologies. *Cf. id.* ¶ 137. As discussed, competitors can only provide high quality VoIP services if the ILECs comply with appropriate CoS and QoS for the CLECs' VoIP packets. As these new technologies are deployed, benchmarking comparisons will remain crucial to establish performance standards in the first instance.

Yet the proposed merger will diminish or eliminate entirely regulators' ability to rely on benchmarking to regulate the RBOCs' conduct. As the Commission has held, "a merger that reduced the number of major incumbent LECs from four to three would so severely diminish the Commission's ability to benchmark that *it is difficult to imagine that any potential public interest benefit could outweigh such a harm*." *Id.* ¶ 170 (emphasis added). In fact, the number would likely be two after the merger, since only Verizon and the merged AT&T-BellSouth could be used as benchmarks for each other. This means that, in the case of "average practice" benchmarking discussed below, Verizon and AT&T-BellSouth would each have an incentive to take into account the effect of its own behavior on any benchmark that might be established by regulators, rendering that form of benchmarking less effective (and likely useless) as a regulatory tool. In the case of "best practice" benchmarking, also discussed below, the number of alternatives available from which to choose the "best" would be reduced (again, likely rendering this form of benchmarking useless). In both cases, the result would be harm to competition and consumer welfare.

A. The FCC And The States Have Used RBOC Benchmarking Extensively.

The FCC and state commissions have long used benchmarking to regulate BOC behavior and they continue to do so. Benchmarking falls into three general categories: best practice benchmarking, average practice benchmarking and worst practice benchmarking.

1. Best Practice Benchmarking

As the FCC has explained, in best practice benchmarking, "a regulator compares behavior across a group of similarly situated, independent firms in order to identify the best practice employed by a firm." *SBC/Ameritech Order* ¶ 111. The fact that one BOC is able to implement a particular practice provides the Commission with probative evidence that other, similarly situated BOCs could implement the same practice. Similarly, if several BOCs "provide widely varying estimates of the cost of providing a certain service, then the low cost estimate would call into question the accuracy of the higher cost estimates." *Id.*

The Commission and the states have implemented best practice benchmarking in numerous situations over the last 25 years, beginning with proceedings growing out of the MFJ. For instance, as the FCC has observed, the BOCs petitioned to remove the MFJ's line of business restrictions based on the fact that "the performance of one RBOC could be measured against []

others." *Id.* ¶ 126.[75] The D.C. Circuit agreed and held that "[t]he existence of seven [R]BOCs increases the number of benchmarks that can be used by regulators to detect discriminatory pricing."[76] Furthermore, as the FCC indicated, "federal courts regularly employed benchmarking by comparing practices among the RBOCs." *Id.* ¶ 129.[77]

The manner in which the FCC implemented number portability shortly after the passage of the 1996 Act provides a prime example of best practice benchmarking. In that case, several RBOCs claimed that the QOR method of porting was not cost-effective, and asked the Commission to allow them to use the LRN method instead. The Commission disagreed, and held that the QOR would in fact be cost-effective based on Ameritech's experience implementing QOR.[78]

The FCC's interconnection policy is almost completely reliant on best-practice benchmarking. For example, the FCC held in the *Local Competition First Report and Order* that interconnection at a particular point on LEC A's network creates a presumption that interconnection at a similar point is possible on LEC B's network. *See Local Competition First*

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[75] In fact, prior to the SBC/Ameritech merger proceeding, "the RBOCs had been among the most fervent proponents of the use of benchmarking to supplant other more-intrusive forms of regulation." *SBC/Ameritech Order* ¶ 126.

[76] *See id.* ¶ 127 (citing *United States v. Western Elec. Co.*, 993 F.2d 1572, 1580 (D.C. Cir. 1993)).

[77] *See id.* ¶ 129 ("[I]n ordering Pacific Bell to provide access lines for AT&T's coinless public telephones, the district court twice noted that Pacific Bell appeared to be the only RBOC not providing the required access. Ruling on a separate motion, the court noted that no other RBOC had attempted, as Bell Atlantic had, to sell embedded CPE to the General Services Administration prior to the divestiture-related assignment of CPE accounts, assets and employees of AT&T.").

[78] *Telephone Number Portability*, First Memorandum Opinion and Order on Reconsideration, 12 FCC Rcd 7236, ¶ 38 (1997).

Report and Order ¶ 204. In that same order, the FCC concluded that it was technically feasible for ILECs to provide access to OSS functions in part because "several incumbent LECs, including NYNEX and Bell Atlantic, are already testing and operating interfaces that support limited [OSS] functions …." *Id.* ¶ 520. In 1998, the FCC requested comment on the feasibility of cageless collocation because "U.S. WEST is currently offering a cageless collocation arrangement, and SBC is permitting competitive LECs to share collocation space."[79] In a subsequent order the FCC ordered cageless collocation based on evidence that certain ILECs were providing the service.[80]

The FCC described many instances of states relying on comparative practices analyses in its prior RBOC merger orders. *See, e.g., SBC/Ameritech Order* ¶¶ 136-139. Since that time, states and the FCC (when standing in the shoes of states to arbitrate interconnection disputes) have continued to employ best-practice benchmarking, primarily during interconnection arbitrations. Following are illustrative examples:

- The Indiana commission held that BellSouth's voluntarily agreement with Level 3 to exchange all traffic over a single trunk group "substantially if not completely justifies approval of Level 3's request" for SBC to do the same.[81]

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[79] *Deployment of Wireline Services Offering Advanced Telecommunications Capability et al.*, Memorandum Opinion and Order and Notice of Proposed Rulemaking, 13 FCC Rcd 24011, ¶ 139 (1998).

[80] *See Deployment of Wireline Services Offering Advanced Telecommunications Capability*, First Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 4761, ¶ 45 (1999) (holding that one ILEC's deployment of a particular type of collocation establishes a rebuttable presumption that it is generally technically feasible for other incumbent LECs to provide the same collocation arrangement).

[81] *Level 3 Communications, LLC's Petition for Arbitration Pursuant to Section 252(b) of the Communications Act of 1934, As Amended by the Telecommunications Act of 1996, and the Applicable State Laws for Rates, Terms, and Conditions of Interconnection with Indiana Bell Telephone Company d/b/a SBC Indiana*, Opinion, Cause No. 42663 INT-01, 2004 Ind. PUC LEXIS 465, at *67 (Dec. 22, 2004).

- The Arizona commission agreed with Level 3 that Qwest should be required to implement an alternative proposal for ISP-bound traffic pricing because Level 3 "has presented evidence that this alternative pricing proposal is being used by BellSouth, Verizon, and SBC."[82] That same order also required Qwest to provide interconnection trunks within 15 days of a request because "[this] proposal[] is consistent with intervals examined by the FCC in its recent orders granting Section 271 authority in Texas, Kansas and Oklahoma." 2000 Ariz. PUC LEXIS 4, at *20.

- The Colorado commission agreed with (legacy) AT&T that Qwest should be required to submit to certain billing practices in part because AT&T has "received better terms than Qwest proposes in a separately negotiated contract with SBC ...."[83]

- The Illinois commission held that, because BellSouth provides "splitter functionality on a bulk basis to Covad," Ameritech would be required to do so as well.[84]

- The Florida commission held that BellSouth should be permitted to use splitter cards when testing DSL service because "[a]ccording to Covad, SBC employs the splitter cards, which are not as expensive as bantam jacks."[85]

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[82] *Petition of Level 3 Communications, LLC for Arbitration Pursuant to Section 253(b) of the Communications Act of 1934, as Amended by the Telecommunications Act of 1996, with Qwest Corporation Regarding Rates, Terms and Conditions for Interconnection*, Opinion and Order, Dkt. No. T-03654A-00-0882 *et al.*, Decision No. 63550, 2000 Ariz. PUC LEXIS 4, at *11 (Apr. 10, 2000).

[83] *Petition of Qwest Corporation for Arbitration of an Interconnection Agreement with AT&T Communications of the Mountain States, Inc. and TCG-Colorado Pursuant to 47 U.S.C. § 252(b)*, Initial Commission Decision, Dkt. No. 03B-287T, Decision No. C03-1189, 2003 Colo. PUC LEXIS 1149, at *149 (Oct. 14, 2003).

[84] *Covad Communications Company Petition for Arbitration Pursuant to Section 252(b) of the Telecommunications Act of 1996 to Establish an Amendment for Line Sharing to the Interconnection Agreement with Illinois Bell Telephone Company d/b/a Ameritech, and for an Expedited Arbitration Award on Certain Core Issues; Rhythms Links, Inc.; Petition for Arbitration Pursuant to Section 252(b) of the Telecommunications Act of 1996 to Establish an Amendment for Line Sharing to the Interconnection Agreement with Illinois Bell Telephone Company d/b/a Ameritech, and for an Expedited Arbitration Award on Certain Core Issues*, Arbitration Decision, 00-0312 - Consol. 00-0313, 2000 Ill. PUC LEXIS 660, at *36-*37 (Aug. 17, 2000).

[85] *Petition by DIECA Communications, Inc. d/b/a Covad Communications Company for Arbitration of Unresolved Issues in Interconnection Agreement with BellSouth*

- The Tennessee commission determined that it was technically feasible for BellSouth to install NGDLC line cards, in part because SBC was already doing so.[86]

- In its 2003 order setting TELRIC rates for Virginia, the FCC relied on a cost study filed by BellSouth in Kansas and Louisiana to set forward looking rates for feeder and distribution plant for Verizon in Virginia.[87] The FCC also relied upon a cost study for aerial structure investment inputs because SBC and BellSouth, among others, indicated that the study was reasonable. *See Virginia TELRIC Order* ¶ 299.

The FCC has also relied on best-practice benchmarking in regulating RBOC entry into the interexchange market.[88]

- In its *New York 271 Order*, the FCC noted that Bell Atlantic was able to process order volumes much faster than BellSouth and Ameritech. This comparison provided evidence that Bell Atlantic's systems were working at a level that would permit entry.[89]

Telecommunications, Inc., Final Order on Arbitration, Dkt. No. 001797-TP, Order No. PSC-01-2017-FOF-TP, 2000 Fla. PUC LEXIS 1185, at *124 (Oct. 9, 2001).

[86] *See Generic Docket to Establish UNE Prices for Line Sharing Per FCC 99-355, and Riser Cable and Terminating Wire as Ordered in TRA Docket 98-00123*, Order on Petition for Stay and Requests for Reconsideration and Clarification, Dkt. No. 00-00544, 2002 Tenn. PUC LEXIS 196, at *11 (June 27, 2002).

[87] *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration in the Matter of Petition of AT&T Communications of Virginia Inc., Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia Corporation Commission Regarding Interconnection Disputes With Verizon Virginia Inc.*, Memorandum Opinion and Order, 18 FCC Rcd 17722, ¶¶ 289-291 (2003) ("*Virginia TELRIC Order*").

[88] *See SBC/Ameritech Order* n.297 (noting several Section 271 orders where the FCC has relied on benchmarking between RBOCs).

[89] *See Application by Bell Atlantic New York for Authorization under Section 271 of the Communications Act to Provide In-Region, InterLATA Service in the State of New York*, Memorandum Opinion and Order, 15 FCC Rcd 3953, ¶ 165 (1999) ("*New York 271 Order*"); *id.* n.508.

- After providing information on the percentage of troubles 30 days after hot-cut installation, the FCC requested that SBC Texas submit additional hot-cut data that was on the same 7-day interval as was provided in the *New York 271 Order.*[90] The clear implication of this requirement was that an apples-to-apples comparison between Bell Atlantic and SBC would assist regulators in scrutinizing the BOCs' behavior.

- Based on a comparison of BellSouth's billing completion notifier in Louisiana and Georgia with a similar system used by Bell Atlantic in New York, which the Commission had previously found was adequate, the Commission held that BellSouth's system was permissible.[91]

2. Average Practice Benchmarking

Another key tool for regulators in monitoring RBOC behavior is "average practice" benchmarking. A regulator employs average practice benchmarking by obtaining data from a number of similarly situated carriers "in order to identify the prevailing standard or to calculate the average, which then could be used as a benchmark against which to evaluate an individual LEC's performance." *See SBC/Ameritech Order* ¶ 112.

The FCC and states have relied on average practice benchmarking primarily in setting rates. Until 2000, the FCC used industry-wide measures of productivity to set its x-factor for access services. In 1997, the FCC relied on a series of multi-year averages of the RBOCs' productivity to set its x-factor to 6.5 percent.[92] On appeal, the D.C. Circuit struck down the x-

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[90] *See Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance; Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-Region, InterLATA Services In Texas*, Memorandum Opinion and Order, 15 FCC Rcd 18354, n.777 (2000).

[91] *See Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., And BellSouth Long Distance, Inc for Provision of In-Region, InterLATA Services In Georgia and Louisiana*, Memorandum Opinion and Order, 17 FCC Rcd 9018, ¶ 175 & n.577 (2002).

[92] *See Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order in CC Dkt. No. 94-1 and Second Report and Order in CC Dkt. No. 96-262, 12 FCC Rcd 16642 (1997), *aff'd in part, rev'd in part, USTA v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

factor, but in so doing it did not question the FCC's reliance on industry wide-studies of productivity in general.[93] On remand in the *CALLS Order*, the FCC set the x-factor not in relation to RBOC productivity, but so as to align rates more closely to the RBOCs' costs.[94] To ensure that these rates were appropriate, the FCC looked to the average of the RBOCs' costs for particular "baskets" of service. For example, the FCC targeted price reductions to the traffic sensitive basket because ARMIS data indicated that the average relative earnings in that basket were higher than in other baskets. *See CALLS Order*. ¶ 170.[95] The Commission held that the target interstate access rate ultimately adopted was appropriate, because average industry data showed that the rate of return for such services was relatively high.[96] The target rates were "within the range of estimated economic costs of switched access that have been presented to the Commission." *Id.* ¶ 176.

The States and the FCC have also relied on average practice benchmarking in setting forward looking rates for UNEs under TELRIC. For example, in 1999, the Ohio commission set the cost of common equity using a proxy group of 7 ILECs which were selected because of their

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[93] *USTA v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

[94] *See CALLS Order* ¶ 2.

[95] As the FCC has held, the very purpose of ARMIS reporting is to assist with benchmark comparisons. *See Policy and Rules Concerning Rates for Dominant Carriers*; *Amendment of Part 61 of the Commission's Rules to Require Quality of Service Standards in Local Exchange Carrier Tariffs*, Memorandum Opinion and Order 12 FCC Rcd 8115, ¶ 57 (1997) ("From the inception of the monitoring program, benchmarking has been a primary goal.").

[96] *See CALLS Order* ¶ 175; *id.* n.385 ("[T]he weighted arithmetic mean for all price cap LECs' interstate rate of return was 18.52 percent, up from 16.52 percent for 1998.").

similar characteristics.[97] The District of Columbia commission took a similar "proxy group" approach to set the common cost of capital for TELRIC purposes in a 2004 order.[98] The FCC did the same in its 2003 Virginia TELRIC proceeding using proxy groups to set the cost of debt, *see Virginia TELRIC Order* ¶ 67, and the cost of equity capital, *see id.* ¶ 74.

3. Worst Practice Benchmarking

Regulators employ "worst-practice" benchmarking to identify and correct sub-standard behavior. For example, on reconsideration of the *Local Competition Order*, the FCC determined that it was technically feasible for RBOCs to provide shared transport because only Ameritech, among all filing RBOCs, asserted that it was unable to provide shared transport.[99] In another instance, the FCC examined all price cap LECs' penetration ratios for residential second lines.[100] Based on this industry-wide comparison, the FCC determined that SNET had under-represented its penetration ratio so that it could charge higher access rates.[101]

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[97] *Application of Cincinnati Bell Telephone Company for Approval of a Retail Pricing Plan Which May Result in Future Rate Increases and For a New Alternative Regulation Plan*, Supplemental Opinion and Order, Case No. 96-899-TP-ALT, 1999 Ohio PUC LEXIS 620, at *26-*27 (Nov. 4, 1999).

[98] *Implementation of the District of Columbia Telecommunications Competition Act of 1996 and Implementation of the Telecommunications Act of 1996*, Opinion and Order, Formal Case No. 962, Order No. 12610, 2002 D.C. PUC LEXIS 421, at *154-*155 (Dec. 6, 2002).

[99] *See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Third Order on Reconsideration and Further Notice of Proposed Rulemaking, 12 FCC Rcd 12460, n.77 (1997) ("Ameritech is the only party to contend that it is not currently able to measure and bill for shared transport. In contrast, Bell Atlantic, NYNEX, and PacTel have stated that they offer shared transport in conjunction with unbundled local switching.").

[100] *See Tariffs Implementing Access Charge Reform*, Memorandum Opinion and Order, 13 FCC Rcd 14683, ¶¶ 29-31 (1998).

[101] *See 1998 Annual Access Tariff Filings*, Memorandum Opinion and Order, 13 FCC Rcd 24001, ¶ 15 (1998).

B. Regulators Will Continue To Need To Rely On Benchmarking In The Future

Going forward, the FCC must continue to rely upon benchmark comparisons to efficiently regulate RBOCs. For example, although all RBOCs have been approved to offer in-region interexchange services, the Commission has held that benchmarking provides an important tool to prevent "possible backsliding by RBOCs" in their compliance with the provisions of Section 271. *See SBC/Ameritech Order* ¶ 148. Then Commissioner Martin indicated that it is crucial that RBOC behavior continues to be monitored after the grant of 271 authority.[102] Indeed, many parties and the FCC itself have initiated enforcement actions against the RBOCs for violations of Section 271, resulting in forfeiture orders and consent decrees.[103] There is every reason to believe that more such enforcement actions will be filed in the future, and retention of reliable benchmarks will be crucial in scrutinizing RBOC behavior in these proceedings.

The establishment of any new price cap regime for RBOC special access will likely be heavily reliant on average-practice benchmarking as well. In its most recent NPRM on special access price regulation, the FCC sought comment from the RBOCs regarding their costs and productivity in an effort to determine what kind of data could be used to fashion an appropriate x-factor going forward. For example, the FCC sought comment on whether special access rates should be set with respect to historic, embedded or forward looking costs.[104] The selection of

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[102] *See Section 272 Sunsets for SBC in the State of Texas by Operation of Law on June 30, 2003 Pursuant to Section 272 (f)(1)*, Public Notice, Concurring Statement of Kevin Martin, 18 FCC Rcd 13566 (2003).

[103] *See* FCC Enforcement Bureau, *Local Telephone Competition Enforcement Actions*, *available at* http://www.fcc.gov/eb/LoTelComp/enf.html.

[104] *See Special Access Rates for Price Cap Local Exchange Carriers et al.*, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994, ¶ 31 (2005) ("*Special Access NPRM*").

any of these options will undoubtedly require comparisons among the RBOCs' costs. The FCC further requested that all RBOCs submit their "expense matrix" to the FCC for the purpose of setting an appropriate x-factor. *See Special Access NPRM* ¶ 36. In the notice itself, the Commission relied on ARMIS benchmarks to compare the growth in ILEC access lines to their rates of return. *See id.* ¶¶ 27-29.

Furthermore, the Commission will need to rely on benchmarking for the establishment of regulations governing access to inputs needed to provide newly deployed packetized and IP-based services. As discussed in Section IV, it is already possible to use BellSouth's behavior as a best-practice benchmark for determining that AT&T's **[proprietary begin]**

[proprietary end] is unreasonable.

C. Benchmarking Is Only Effective If Firms Are Of Comparable Scale and Scope.

Both the states and the FCC have recognized that, for benchmarking to be effective, the benchmarked companies must be of similar size. As the Commission has held,

> Comparative practices analyses are most effective when the firms are similarly situated, including the size of the firms relative to the size of the market. With comparable firms – e.g., in their customer base, access to capital, network configuration and the volume and type of demands from competitors – regulators and competitors can establish more effectively that approaches and rates adopted by one incumbent would be equally feasible for other incumbents.

Bell Atlantic/GTE Order ¶ 153.[105] The behavior of smaller LECs such as AllTel and Sprint (now Embarq) cannot serve as a useful benchmark to the RBOCs in many contexts because, among other things, smaller ILECs generally serve less dense areas and are therefore subject to less

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[105] *See also SBC/Ameritech Order* ¶ 103 ("[T]he major incumbent LECs (RBOCs and GTE), because they are of similar size and face similar statutory obligations and market conditions, remain uniquely valuable benchmarks for assessing each other's performance."); *id.* ("The Bell Companies, being of similar size, history and regional concentration have, to date, been useful benchmarks of each other's performance.").

competition than the RBOCs. Moreover, smaller ILECs' networks may be configured in a different manner than the RBOCs', preventing direct comparisons. *See id.* ¶ 160. The Commission took these differences among RBOCs and smaller ILECs into account in its *CALLS Order* where it held that "the lower target rate of 0.55 cents is reasonable for the larger BOC LECs and GTE due to their economies of scale and broad subscriber bases. We find that a slightly higher target rate of 0.65 cents is reasonable for other LECs that, by definition, do not have the subscriber bases and resources of the larger BOCs." *CALLS Order* ¶ 75. With respect to average-practice benchmarking, the Commission held that "no small incumbent LEC could provide an adequate counterpoint to the combined entity's control of one third of the nation's access lines." *Bell Atlantic/GTE Order* ¶ 160. This conclusion could only have more force in the present merger, where the Applicants would control over 40 percent of the nation's access lines post-merger.

Similarly, state commissions have taken into account the differences between the RBOCs and smaller carriers in their benchmarking analyses. In setting the price of collocation, Sprint's ILEC subsidiary argued to the Florida commission that it would make little sense to use Sprint's cost factors to set the cost factors for BellSouth because "BellSouth is much larger than Sprint, with greater economies of scale ...."[106] The Florida commission agreed and did not adopt a unitary cost model for Verizon, BellSouth and Sprint in Florida. *See* 2004 Fla. PUC LEXIS 795, at *12-*13.

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[106] *See Petition of Competitive Carriers for Commission action to support local competition in BellSouth Telecommunications, Inc.'s service territory*, Final Order, Dkt. No. 981834-TP/990321-TP; Order No. PSC-04-0895-FOF-TP, 2004 Fla. PUC LEXIS 795, at *8 (Sept. 14, 2004).

The available evidence indicates that Qwest may already be too small and structurally different from the other three RBOCs to be considered valuable for benchmarking purposes. If the present merger is consummated, Qwest will almost certainly not qualify as a benchmark for Verizon and the merged AT&T-BellSouth. If approved, the merger would only leave a single effective comparator for benchmarking the performance of either Verizon or the merged AT&T-BellSouth, increasing substantially the merger's public interest harms.

As described above in Section IV, based on either access lines or revenues, Qwest is smaller than Verizon or a merged AT&T-BellSouth by much more than a 2:1 ratio. *See RBOC Market Share Chart*. As Professors Mitchell and Farrell have suggested, large differences in size may well make benchmarking more difficult and a more than 2:1 size differential reduces the value of benchmarking.[107] Its smaller scale and scope prevents Qwest from providing the same level of service as other RBOCs and will impair Qwest's ability to deploy new advanced services, for which benchmarks do not yet exist. For example, unlike BellSouth, AT&T and Verizon, Qwest has not announced plans to deploy television service over its own facilities to any substantial degree. Qwest has not begun to deploy FTTC or FTTH networks, nor does Qwest sell its own wireless service. If Qwest cannot provide the same advanced services offered by Verizon and a combined AT&T-BellSouth, it will be impossible to provide benchmark comparisons between Qwest and the two remaining RBOCs for such services.

State commissions have already begun removing Qwest from their benchmarking analyses. For example, the California commission recently set SBC's cost of capital for TELRIC

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[107] *See* Joseph Farrell and Bridger M. Mitchell, *Response to Some Criticisms of Benchmarking Analysis*, Apr. 9, 1999, at 14, attached to *Ex Parte* Letter of Michael Jones, Counsel, Sprint, to Magalie Roman Salas, Secretary, FCC, CC Dkt. No. 98-141 (Apr. 12, 1999).

by relying on a "proxy group" of companies of similar size. For its proxy group, SBC put forth for consideration several LECs, including Qwest and Broadwing. AT&T and MCI proposed using only SBC, Verizon and BellSouth. AT&T and MCI argued that Qwest and Broadwing should be excluded because "they are much smaller, experiencing major financial difficulties, and investors perceive greater risk from these two companies."[108] The California commission agreed and excluded both Qwest and Broadwing from the proxy group, leaving only SBC, Verizon and BellSouth. *See* 2004 Cal. PUC LEXIS 476, at *221.

D. The Merger Will Substantially Diminish Or Eliminate Entirely Regulators' Ability To Rely On Benchmarking.

As the Commission has found, the loss of an RBOC to merger impairs regulators' ability to perform benchmarking analysis among the remaining RBOCs, resulting in substantial public interest harms.[109] These harms stem from three main sources: (1) fewer RBOCs provide fewer "data-points" for a regulator to analyze in its benchmarking analysis; this increases the likelihood of errors and, as a result, leads regulators to use benchmarking more cautiously and to forego some benefits of the data that are still available; (2) fewer RBOCs make it less likely that there is

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[108] *See Joint Application of AT&T Communications of California, Inc. (U 5002 C) and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Switching in Its First Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050 et al.*, Opinion Establishing Revised Unbundled Network Element Rates for Pacific Bell Telephone Company DBA SBC California, Application 01-02-024 *et al.*, Decision 04-09-063, 2004 Cal. PUC LEXIS 476, at *220 (Sept. 23, 2004).

[109] *See Bell Atlantic/GTE Order* ¶ 127 ("We find that the proposed merger of Bell Atlantic and GTE would pose a significant harm to the public interest by severely handicapping the ability of regulators and competitors to use comparative practices analysis as a critical, and minimally intrusive, tool for achieving the objectives of the 1996 Act."); *SBC/Ameritech Order* ¶ 104 (The "elimination of Ameritech … will significantly impede the ability of th[e] Commission, state regulators, and competitors to use comparative practices analyses…."); *NYNEX/Bell Atlantic Order* ¶ 16 ("As diversity among carriers declines, both this commission and state commissions may lose the ability to compare performance between carriers that have made different management or strategic choices.").

a "model" RBOC against which a "best-practice" can be established for all RBOCs; and (3) fewer RBOCs increase the likelihood that the remaining firms will take account of their own behavior on the "average" benchmarks to which they are subject. *See Bell Atlantic/GTE Order* ¶ 134.

Post-merger, the combined entity would likely adopt uniform practices wherever possible. The merging of practices will result in a decline in "the level of experimentation and variety of approaches observable to regulators and competitors." *Id.* ¶ 135. Fewer RBOCs means that there is less chance that a single firm with a high benchmark standard "may establish a best practice in the industry." *Id.* ¶ 136; *see also SBC/Ameritech Order* ¶ 116. Therefore, the new "best" practice is likely to become worse. *See id.* Moreover, fewer data points means that it is much harder to detect and punish below-par performance through worst practice benchmarking; indeed it is uncertain where "par" should be. *See id.*

The Commission has recognized that fewer data-points will result in a decreased ability for regulators to make "decisions regarding new services and innovative technologies." *Bell Atlantic/GTE Order* ¶ 136; *see also SBC/Ameritech Order* ¶ 117. Fewer RBOCs makes it much harder to "evaluat[e] whether or when to require the offering and interconnection of the new service or technology." *Bell Atlantic/GTE Order* ¶ 137. This is especially true with regard to the technical feasibility of providing the inputs (such as new transmission facilities or high packet CoS and QoS) required by competitors to deploy advanced services. *See id.* The likelihood of harm with respect to advanced services is exacerbated because ILECs already have an increased incentive to "deny special accommodations required by competitive LECs seeking to offer innovative advanced services that the incumbent may not even offer." *SBC/Ameritech Order* ¶ 107.

The present merger will result in an increase in the number of operating companies under the same holding company, thereby reducing the incentive for experimentation at the operating company level. *See Bell Atlantic/GTE Order* ¶ 138.[110] This is because, as the overall size (and therefore footprint) of the merged RBOC increases, "the cost it incurs when one of its operating companies' practices is used as a benchmark against the rest of the company also increases." *See id.* Therefore, the merged company will have an incentive to unify its operating companies' practices at a lower level of performance. *See id*; *see also SBC/Ameritech Order* ¶ 118. It is for this reason that the merged firm would likely replace BellSouth's somewhat more cooperative approach to supplying Ethernet transmission facilities with AT&T's refusal to offer such facilities on reasonable terms and conditions.

The Commission held that the merger of Bell Atlantic and GTE would have a "direct impact on the industry's average benchmarks" when the combined company served approximately one third of access lines nationwide. *Bell Atlantic/GTE Order* ¶ 148. Such an impact will be even more pronounced now that the combined entity will have, post-merger, over a 40 percent share of access lines. *See RBOC Market Share Chart*. Such dominance will severely harm the ability of the FCC to perform average practice benchmarking because the combined firm will "dominate the setting of industry averages." *Bell Atlantic/GTE Order* ¶ 139. The absence of benchmark firms is especially problematic in setting average productivity factors

[110] States often use a single operating company of a holding company to benchmark against another operating company under that same holding company. As the FCC explains, "the Michigan PUC's requirement that Ameritech implement number portability in Michigan uses Ameritech's progress in Illinois as a benchmark." *SBC/Ameritech Order* ¶ 139.

for price cap regulation[111] or in similar situations where a carrier performance above the norm will actually raise the benchmark in the future. In markets with few firms to benchmark, the high performing firm is "taxed" out of the benefits of its high performance because the high performing firm will have a disproportionate effect on a new x-factor established several years down the road. This "ratchet effect" decreases the incentive for firms to improve their performance.[112] Because of its size and the operation of the "ratchet effect," a combined AT&T-BellSouth would likely have an incentive to reduce its performance to a lower level. *See Farrell/Mitchell Decl.*[113]

Perhaps most seriously, any further reduction in the number of RBOCs will "increase the likelihood of coordination, either tacit or explicit, among the remaining firms." *SBC/Ameritech Merger* ¶ 121. Coordination could involve (1) an agreement to settle on a lower benchmark[114] or (2) concealing information concerning operating practices and dealings with competitors. *See id.* ¶ 123. The harm from collusion does not increase in a linear fashion as the number of RBOCs decreases. Rather, each RBOC merger "materially increases the risk that the remaining firms

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[111] Although the current price cap regime is not set with respect to RBOC productivity, the Commission is currently fashioning a new regime for special access price regulation, which may again include price caps set with respect to RBOC-wide productivity.

[112] *See Petition to Deny of Sprint Communications Co. L.P.*, Decl. of Joseph Farrell and Bridger M. Mitchell, *Benchmarking and the Effects of ILEC Mergers*, CC Dkt. No. 98-141, at 38-41 (Oct. 15, 1998) ("*Farrell/Mitchell Decl.*").

[113] *See also SBC/Ameritech Order* ¶ 120. ("An incumbent LEC with few operating companies, for example, may allow its local operating companies to set the non-recurring charge (NRC) associated with cutting over a loop, because the data from its operating companies will have negligible impact on the industry average. If however, as a result of the merger, the holding company controlled a large percentage of the nation's local loops, then it would have a strong incentive to establish a uniform NRC in order to influence the industry average.").

[114] As explained in Section IV above, the merged entity will have an increased incentive to degrade service provided to competitors, resulting in lower performance overall.

could successfully coordinate behavior, implicitly or explicitly, to reduce the effectiveness of comparative practices analysis." *Id.* ¶ 183. The Applicants argue that a reduction in the number of RBOCs does not harm the ability of regulators to monitor RBOC behavior, because the FCC can rely on "parity" comparisons.[115] However, in previous RBOC mergers, the FCC has rejected RBOCs' arguments that "parity" benchmarking could substitute for benchmarking multiple RBOCs' behavior. *See Bell Atlantic/GTE Order* ¶¶ 164-167; *SBC/Ameritech Order* ¶¶ 174-178. There is no reason for the FCC to reach a different conclusion in this case. Indeed, while "parity rules are valuable," they will not be effective if "an incumbent LEC deems it profitable to provide lackluster service or change excessive rates to both its own retail affiliates and its competitors." *Bell Atlantic/GTE Order* ¶ 166. For example, under a parity regime, an incumbent LEC would have an incentive to increase special access rates to both its affiliates and to third parties. Any payments by the affiliate would only serve as an internal transfer within the RBOC, while competitors would be price-squeezed out of providing retail service. This risk only increases as the last of the Section 272 separate affiliates sunset.

In addition, parity rules do not protect entrants that rely on RBOC inputs to serve the marketplace when there is no "retail analog" provided by the RBOCs to provide a parity comparison.[116] This is the case, for example, where TWTC sought **[proprietary begin]**

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[115] *See Public Interest Statement* at 122, n.413. Parity comparisons focus on "how an incumbent LEC treats competitive LECs vis-à-vis itself." *Bell Atlantic/GTE Order* ¶ 164.

[116] *See New York 271 Order* ¶ 45 ("Where the BOC, however, does not provide a retail service that is similar to its wholesale service, its actual performance with respect to competitors cannot be measured against how it performs for itself because the BOC does not perform analogous activities for itself.").

[proprietary end] AT&T apparently does not perform this function for its retail Ethernet customers and a parity standard is therefore unavailable.

This is also the case where competitors seek to offer advanced services not yet offered by the RBOC. As the Commission has observed, "if the [competitors'] innovation requires a new form of interconnection or access, the incumbent can slow-roll the innovator, declining to provide the new kind of input, until the incumbent has a similar or leapfrogging innovation available." *SBC/Ameritech Order* ¶ 177 (internal citations omitted). For example, CLECs generally rolled-out DSL service ahead of the RBOCs. To provide DSL service, CLECs required conditioned loops with bridge-taps and load coils removed. Under a parity regime, RBOCs would not have to provide loop conditioning until they provided DSL themselves. As a result, CLECs would have been stymied in their deployments, competition would have been harmed and new service innovations would have remained unavailable to the public. *See id.* This is a crucial concern moving forward as the network shifts to an all packet switched environment and CLECs remain reliant on RBOC facilities and non-discriminatory behavior to provide these services.

The loss of BellSouth as an independent company will be especially harmful because there are indications that it is a "maverick" firm on certain issues.[117] The utility of best practice benchmarking greatly increases with the presence of a "maverick" firm. That is, a firm which, for whatever reason, has "a greater economic incentive to deviate from the terms of coordination than do most of their rivals *(e.g.*, firms that are unusually disruptive and competitive influences

[117] *See SBC/Ameritech Order* ¶ 149 (noting that the "loss of Ameritech's independence would be especially severe because Ameritech frequently has taken an approach that differs from the position taken collectively by the other RBOCs."). To the extent that BellSouth is acting as a maverick, it is likely doing so because it has a smaller footprint than the other two major RBOCs.

in the market)."[118] The loss of a maverick firm as an independent company would harm the ability of the FCC to benchmark more than the loss of either Verizon or AT&T.[119]

For example, in 2002, BellSouth urged that the FCC adopt detailed special access performance metrics.[120] In proposing its metrics, BellSouth provided evidence, based on comparative ARMIS data, that its special access performance was superior to the "ILEC average" on various metrics.[121] At the time, the other RBOCs argued that such performance metrics were unnecessary and would be too burdensome to implement.[122] The Joint Competitive Industry Group ("JCIG"), a coalition of CLECs and IXCs pressing for more detailed performance standards, praised BellSouth's proposal as substantially similar to its own proposal.[123] As JCIG noted, the willingness of BellSouth to implement detailed performance metrics "strongly indicates that there is no obstacle or sound rationale that would prevent the other incumbent LECs from doing so." *Id.* However, BellSouth soon dropped its support for its

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[118] *Merger Guidelines* § 2.12.

[119] *See id.* ("[A]cquisition of a maverick firm is one way in which a merger may make coordinated interaction more likely, more successful, or more complete.").

[120] *See* Letter of W.W. Jordan, Vice President-Federal Regulatory, BellSouth, to Marlene H. Dortch, Secretary, FCC, WC Dkt. No. 01-321 (Aug. 26, 2002) ("*BellSouth Aug. 26 Letter*").

[121] *See Special Access Performance Measurements*, Presentation by BellSouth, Aug. 23, 2002, at 4, attached to *BellSouth Aug. 26 Letter*.

[122] *See, e.g.*, *Ex Parte* Letter of Albert M. Seyeles, Executive Director-Federal Regulatory, SBC Telecomm., Inc., to William H. Caton, Acting Secretary, FCC, WC Dkt. No. 01-321 (Apr. 4, 2002).

[123] *See* Letter of The Joint Competitive Industry Group to Marlene H. Dortch, Secretary, FCC, WC Dkt. No. 01-321, at 2 (Sept. 26, 2002).

proposed metrics, and joined the other three RBOCs in proposing watered down metrics based solely on a parity standard.[124]

Even though BellSouth capitulated to the other RBOCs in its special access performance metrics advocacy at the FCC, BellSouth provides substantially better performance metrics and pricing terms in its contract tariffs than AT&T.[125] *First*, BellSouth agreed to track and abide by seven separate metrics, *see BellSouth Tariff* § 25.29.2, while AT&T only agreed to three, *see AT&T Tariff* § 33.56.5. *Second*, under BellSouth's tariff, penalties for failure to meet the tariff benchmarks would be paid directly to TWTC. *See BellSouth Tariff* § 25.29.2(B). The "penalties" in AT&T's contract merely mandate that AT&T expend money to improve its performance. *See AT&T Tariff* § 33.56.5(F). If AT&T's poor performance stems from a desire to discriminate, not a system malfunction, such a penalty will do little to improve behavior. Moreover, it will be difficult for a third party to ensure that the money is spent appropriately. *Third*, AT&T's tariff contains the extremely onerous provision, conditioning its special access discounts on TWTC's willingness to only purchase 2% of its annual revenue commitment as UNEs. *See AT&T Tariff* § 33.56.3(E). BellSouth's tariff does not contain a similar condition. *Fourth*, in order to qualify for any discounts, TWTC must only purchase $9 million in qualifying products from BellSouth, *see BellSouth Tariff* § 25.29(E), while SBC requires over $26 million in revenue, a figure that many carriers cannot achieve, *see AT&T Tariff* § 33.56.1.

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124 *See Service Quality Measurement Plan (SQM), Joint BOC Section 272(e)(1) Performance Metrics Proposal*, Dec. 20, 2004, attached to Joint Letter of BellSouth, Qwest, SBC, and Verizon to Marlene H. Dortch, Secretary, FCC, WC Dkt. Nos. 02-112 *et al.* (Dec. 20, 2004).

125 *See* BellSouth FCC Tariff No. 1, § 25.29 *et seq.* - Contract Tariff No. 26 ("*BellSouth Tariff*"); Pacific Bell Telephone Company Tariff FCC No. 1, § 33.56 *et seq.* - Contract Offer No. 56 ("*AT&T Tariff*"). These contract tariffs are the publicly available versions agreements by TWTC with AT&T and BellSouth.

Additionally, BellSouth's conduct in cooperating at least somewhat with TWTC's request for access to Ethernet local transmission facilities offers another example of BellSouth's role as a maverick. As with special access performance measurements advocacy, there is of course the risk that BellSouth's Ethernet practices and performance metrics tariff offerings will fall in line with AT&T's practices even without the merger. But if the merger is approved, that outcome is a virtual certainty and, in any event, BellSouth would be unlikely to show even an initial willingness to cooperate with competitive entry in other contexts after the merger.

E. The Applicants' Argument That RBOC-To-RBOC Benchmarking Is No Longer Necessary Is Without Merit.

The Applicants argue that benchmarking is no longer needed because "access to incumbent LEC local facilities is now more commonly accomplished through individually negotiated commercial arrangements." outside of regulatory oversight. *Public Interest Statement* at 122.[126] It is undoubtedly true that certain inputs, such as Ethernet transmission facilities, QoS and CoS for IP traffic remain largely free of regulation. However, it is absurd for the Applicants to argue that lack of regulation, *ipso facto* means that RBOCs do not have market power over these inputs or cannot exercise that market power in destructive ways. As shown above, the RBOCs, especially AT&T, have taken advantage of this regulatory vacuum to exercise market power over these inputs to discriminate against competitors on both price and non-price terms. The obvious remedy for this problem is more effective regulatory oversight, something that can only be accomplished with the assistance of benchmarking. Fewer RBOCs can only mean that

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[126] The Applicants raised identical arguments with respect to why benchmarking is unnecessary as they did for why the Commission should not be concerned with a larger combined company footprint post-merger. *See Public Interest Statement* at 121-23. As explained above, these arguments have no merit.

the FCC's ability to correct behavior such as AT&T's described above will diminish substantially.

CONCLUSION

The preceding discussion demonstrates that the competitive consequences of the proposed merger are unambiguously negative. The harmful horizontal effects increase the merged firm's stranglehold over local transmission facilities and threaten to tip the Internet backbone market into one where firms with larger market share acquire inefficient incentives. The harmful vertical effects (i.e., changes in the provision of inputs to competitors) of a larger footprint increase the incentive and ability of the merged firm to exploit market power over inputs, such as interconnection, the exchange of IP traffic and local transmission facilities that are necessary for competitors to provide services in the downstream retail market. Finally, the likely elimination of benchmarking as a means of detecting and punishing unreasonable conduct makes this merger a "perfect storm" of anticompetitive consequences

These deleterious effects plainly warrant the conclusion that the merger is contrary to the public interest. The Commission has repeatedly scrutinized prior transactions for their adverse horizontal and vertical effects, including the likelihood that the merged firm will have increased incentives to raise rivals' costs through price and non-price discrimination.[127] In its prior reviews of BOC mergers, the Commission has explained not only that the individual BOCs retain market power in their respective regions but has voiced serious concerns that the merger

[127] *See, e.g.*, *Bell Atlantic/GTE Order* ¶ 173; *Merger of MCI Communications Corp. and British Telecommunications plc*, Memorandum Opinion and Order, 12 FCC Rcd 15351, ¶ 155 (1997) ("[W]e are concerned whether the merger ... will increase the ability or the incentive of the vertically integrated firm to affect competition adversely in any downstream end-user market."); *Sprint Corporation Petition for Declaratory Ruling Concerning Section 310(b)(4) and (d) and the Public Interest Requirements of the Communications Act of 1934, as amended*, Declaratory Ruling & Order, 11 FCC Rcd 1850, ¶¶ 58-60 (1996).

will result in an "incremental increase in that power or misconduct that will result from the proposed transfer."[128] Here, the showing has been plainly made; both the incentive and the ability to engage in anticompetitive conduct worsen with the merger.

The Commission has plenary authority over questions of industry structure. The Commission's statutory mandate extends well beyond merely correcting bad conduct; it obligates the FCC to affirmatively act to assure efficient industry structures which themselves will aid to minimize such conduct. On numerous occasions, reviewing courts have upheld the FCC's use of its broad authority to prescribe a particular industry structure in order to achieve perceived benefits or to avoid potential problems.

The FCC's initial Computer Inquiry proceeding provides a clear example of such action. In *Computer I*, the FCC promulgated regulations which required common carriers to provide non-regulated data services through a structurally separate corporate entity. The Second Circuit upheld the FCC's authority to regulate common carrier entry into the unregulated field of data processing services.

> The burgeoning data processing activities of the common carriers pose, in the view of the Commission, a threat to efficient public communications services at reasonable prices and hence regulation is justified under its broad rule-making authority.[129]
>
> In so doing, the Court rejected petitioners' attempts to narrow the FCC's authority.
>
> It is irrelevant that the [separation] rule is aimed at potential rather than actual domination or restraints, or that the Commission is not certain that the developments forecast will occur if the rule is not enacted.[130]

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[128] *See, e.g., Applications of Pacific Telesis Group, Transferor, and SBC Communications, Inc., Transferee, for Consent to Transfer Control of Pacific Telesis Group and its Subsidiaries*, Memorandum Opinion and Order, 12 FCC Rcd 2624, ¶ 42 (1997); *see also SBC/Ameritech Order* ¶ 186.

[129] *GTE Serv. Corp. v. FCC*, 474 F.2d 724, 730 (2d Cir. 1973).

The Commission's authority over the structure of the industries it regulates extends to outright proscription of certain entities participating in some markets. The FCC's cable-telephone cross-ownership rules promulgated in 1970 and eventually removed by Congress after the rules had served their purpose are a prime example of this.[131] In reviewing the agency's initial decision, the Fifth Circuit explained the Commission's broad authority under the Communications Act, specifically relying upon Sections 151, 152(a), and 214. Moreover, the Commission has exercised its power to review mergers by blocking those that threaten significant harm to consumer welfare, as was the case with the DirecTV-Echostar merger and more recently with XM Radio's now abandoned attempt to purchase WCS.[132]

These cases demonstrate the prophylactic nature of the FCC's powers over industries it regulates. Plainly the FCC has the authority – indeed the obligation – to consider transactions in light of whether they promote efficient market structures. It need not and must not acquiesce in proposals that force it to await the inevitable inefficient outcomes and search for second-best, after-the-fact remedies. It must take a stand now and refuse to permit the consummation of the proposed merger as clearly contrary to the public interest.

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[130] *Id.* at 731 (citation omitted). In *Computer II*, the Commission required AT&T to provide data services through a separate subsidiary and once again the appellate court deferred to the Commission's determination of the appropriate industry structure. *See Computer & Communications Indus. Ass'n v. FCC*, 693 F.2d 198 (D.C. Cir. 1982).

[131] These rules were ultimately codified by Congress, and subject to constitutional challenges. *See Chesapeake & Potomac Tel. Co. of Va. v. United States*, 42 F.3d 181 (4th Cir. 1994), *cert. granted*, 515 U.S. 1157 (1995), *j. vacated*, 516 U.S. 416 (1996). The litigation was mooted by the amendments made by the Telecommunications Act of 1996.

[132] *See* Tony Sanders, *XM, WCS Scrap a $196 Mil. Merger*, Mediaweek (May 22, 2006), *available at* http://www.mediaweek.com/mw/news/recent_display.jsp?vnu_content_id=1002540358.

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