

wireless and wireline telecommunications networks, international telephone rates, and *broadcasting and cable television*. *Dr. Mitchell has testified and/or consulted on a* number of litigation and regulatory matters involving telecommunications, including market definition, interconnection costing and pricing, incentive regulation, anticompetitive behavior, as well as damages from breach of contract and misappropriation of trade secrets. Prior to joining CRA, he taught economics at Stanford University and UCLA and was a Senior Economist at the RAND Corporation. Dr. Mitchell's international experience includes projects in Argentina, Australia, Brazil, Canada, Hong Kong, India, Malaysia, Mexico, New Zealand, Peru, Thailand, Trinidad and Tobago, the United Kingdom, and the European Union; residence at research centers in Berlin and Delft; and consulting assignments with the World Bank. He holds a Ph.D. in Economics from the Massachusetts Institute of Technology.

### **1.2. Purpose**

3. We have been asked by Time Warner Telecom to assess the effects of the proposed merger of AT&T and BellSouth on the likelihood of exclusionary conduct by these carriers and the resulting ability of other carriers to bring competition to telecommunications service and input markets. In particular, we have been asked to analyze the effect of the increase in the size of the service area (the "footprint") that the merged entity would occupy on its incentives to engage in exclusionary behavior. We have also been asked to analyze the effect of the proposed merger on the ability of telecommunications regulators to employ information about the performance of

other ILECs (“benchmarking”) in regulating a merged AT&T-BellSouth as well as other ILECs. We conclude that, by increasing the size of AT&T’s footprint, the merger will threaten the entry by, and the expansion of, innovative rivals such as Time Warner Telecom that need access to the facilities of AT&T and BellSouth in order to compete. We also conclude that the merger will make it more difficult for regulators to use benchmark regulation and thus to detect and prevent such exclusionary conduct.<sup>1</sup>

4. Because a subscriber to a network benefits from being able to communicate with others, and because of the potential inefficiencies associated with building overlapping facilities, it generally is efficient for carriers to rely on one another’s facilities to exchange traffic between their subscribers. Thus, giving competitors access to the ILECs’ networks generates significant benefits in terms of lower costs and higher quality of service.
5. Access can take several forms. For example, carriers may purchase transport and termination from each other in order to complete calls or exchange data traffic that originates on one network and terminates on another. In addition to negotiating to

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<sup>1</sup> We have not been asked to address the effect of the merger on the extent of actual or potential competition between AT&T and BellSouth. However, we cannot resist observing that the merging parties’ claim that they are not direct competitors is completely at odds with the claim, made by SBC when it merged with Ameritech, that the merger would permit it to compete more effectively outside its own service areas, including the service areas served by BellSouth. For example, in his testimony regarding the SBC-Ameritech merger before the Antitrust, Business Rights and Competition Subcommittee, Senate Judiciary Committee, May 19, 1998, Edward E. Whitacre, Jr., Chairman and Chief Executive Officer of SBC stated: “...residential and business consumers in the 30 new markets outside of the companies’ current territory will benefit from the increased competition that will result from our entry into markets....Neither company alone could effectively implement this broad strategy and enter all of these markets in competition with *BellSouth*, Bell Atlantic, USWest, GTE, the large interexchange carriers and CLECs without the companies’ complementary assets and combined strengths.” (emphasis added)

*interconnect their networks, carriers may purchase inputs such as DS1, DS3, or Ethernet loops and transport facilities (collectively "local transmission facilities") from one another. The purchase of inputs from another carrier can be viewed as a form of access because it allows one carrier to use its own facilities in combination with those of another to deliver services to end users. In what follows, we generally will use the term *access* to include both interconnection and the purchase of inputs.*

6. The need for, and value of, access arises whenever multiple carriers provide public services. As a result, the need for access would not disappear even if local competition were vibrant. Moreover, the availability of high-quality, efficiently priced local transmission facilities and interconnection among local networks is a necessary structural prerequisite for local exchange markets to become and remain competitive, especially for carriers like Time Warner Telecom that are bringing advanced services to market and intend to do so in a larger number of geographic areas.
7. If approved, the proposed merger between AT&T and BellSouth would likely increase the merging companies' incentives and ability to engage in exclusionary behavior by impeding efficient access. AT&T and BellSouth currently possess significant market power in the provision of access services in their respective service regions. This is especially so in the business market because, as the available evidence indicates, AT&T and BellSouth control the only local transmission facilities to the vast majority of commercial office buildings in their respective regions. The resulting market power may be exercised by setting high access prices (in the absence

of effective price regulation) or by pursuing exclusionary access policies under which AT&T and BellSouth delay, deny, or degrade the access provided to competing carriers.<sup>2</sup>

8. The proposed merger of AT&T and BellSouth would combine what are today separate and independent local exchange operations and increase the incentives and ability of both companies to disadvantage competitors by reducing the provision of the high-quality, efficient, and innovative forms of access that those competitors require to compete. Moreover, the proposed merger would make it more difficult for state and federal policy makers to use benchmarking to prevent the merged AT&T-BellSouth, as well as other ILECs, from engaging in exclusionary behavior by refusing to provide efficient, high-quality, and innovative access services at reasonable prices to their competitors.

## **2. Time Warner Telecom Continues to be Dependent on Access to ILEC Facilities**

9. AT&T and BellSouth currently possess substantial market power in the provision of access services in both downstream and upstream markets. Downstream markets include those for local exchange services, interexchange services, as well as a variety of innovative telecommunications and information service offerings. Upstream markets are those for the provision of access services to carriers that are, in turn, providers of downstream telecommunications services. For example, Time Warner

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<sup>2</sup> Throughout this Declaration, we use the term *exclusionary* to refer to practices that impair the ability of rival firms to compete, even if the practices do not drive the rivals completely from the market. Thus, it includes conduct that impairs rivals' quality, raises rivals' costs, or slows rivals' entry or expansion.

Telecom participates in downstream markets as a provider of innovative services, including *Ethernet, IP virtual private network, and IP voice services, to business and government customers.*<sup>3</sup> Time Warner Telecom also participates in upstream markets as a buyer of originating and terminating access services and other inputs from ILECs, and also as a provider of transport and termination services to ILECs and other carriers and a provider of local transmission facilities to other carriers.

10. ILECs have market power in the provision of access services in the upstream markets.

This conclusion follows directly from the fact that carriers such as Time Warner Telecom often have no economically feasible alternatives to the use of ILEC facilities (whether through the purchase of special access or of transport and termination inputs) to reach many of their actual or potential subscribers.<sup>4</sup>

11. Examination of the conditions of entry in upstream markets confirms the conclusion that ILECs have significant market power as providers of access services. There are high barriers to entry facing potential entrants into the provision of access services in competition with the ILECs. First, telecommunications markets are characterized by strong network effects. Thus, any CLEC seeking to offer public telecommunications services must itself interconnect with ILEC local exchange networks to be

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<sup>3</sup> See Petition to Deny of Time Warner Telecom In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer Of Control, Federal Communications Commission, WC Docket No. 06-74, June 5, 2006, [hereafter "Petition to Deny"], p. 2. For a more complete description of these services see Declaration of Graham Taylor on Behalf of Time Warner Telecom, Inc., In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer Of Control, Federal Communications Commission, WC Docket No. 06-74, June 5, 2006, [hereafter "Taylor Declaration"], ¶¶ 7-16.

<sup>4</sup> See Reply Declaration of Graham Taylor on Behalf of Time Warner Telecom, Inc., In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer Of Control, Federal Communications Commission, WC Docket No. 06-74, [hereafter "Taylor Reply Declaration"], ¶ 4 and ¶ 7.

competitively viable.<sup>5</sup> The need to interconnect with the ILECs' networks to realize network effects will continue as long as ILECs remain the only way to connect to significant numbers of end users. This need to interconnect with the ILECs' networks gives ILECs the power to limit the threat of entry into their markets by raising entrants' costs, either by raising the price of, or denying, delaying, or degrading, the necessary access.

12. In addition to network effects, there are economies of scale (density) in providing access services. Local network infrastructure has large fixed costs that must be incurred even if a carrier is serving only a small percentage of telephone subscribers in a given area. Thus, small-scale entry is difficult.
13. Finally, an entrant may require inputs from an ILEC to reach locations that are economically infeasible for the entrant to serve. In these cases, the inputs purchased from the ILEC are complements to the entrant's own facilities without which the entrant may not be able to serve a customer at all.<sup>6</sup>
14. Entrants need interconnection with ILECs such as AT&T and BellSouth far more than do AT&T and BellSouth need interconnection with CLECs such as Time Warner Telecom. This is because AT&T and BellSouth serve far more end users than any CLEC. If negotiations over interconnection were to break down, a CLEC would likely

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<sup>5</sup> There is one limited exception. A firm offering solely originating and/or terminating interexchange access could offer service without directly connecting to an ILEC network. That carrier's IXC customers would, however, still need to purchase access from ILECs to reach the vast majority of telecommunications subscribers.

<sup>6</sup> Taylor Declaration (¶ 6) notes that "the incumbent LEC usually owns the only loop facility serving locations to which TWTC cannot efficiently deploy its own loops. Competitive providers usually have not deployed loop facilities serving such locations."

be forced out of business as the result of being unable to offer its customers the ability to make calls to, and receive calls from, the ILEC's network. By contrast, not only would the ILEC not be significantly harmed by the lack of interconnection, it would actually benefit from the weakening of competition and the diversion of CLEC customers to its own retail services. Similarly, given the ubiquity of the ILECs' networks, ILECs are far less likely to require access to inputs supplied by an entrant than an entrant is to need access to inputs that the ILEC supplies.

15. The Commission itself has long recognized that ILECs possess substantial market power. Indeed, this recognition is the basis of the Commission's regulation of special access and unbundled network elements.<sup>7</sup> Moreover, the interconnection provisions of the Telecommunications Act of 1996 also are based on recognition of ILEC market power.<sup>8</sup>

16. In the 10 states in which it operates and in which AT&T or BellSouth is an ILEC, Time Warner Telecom uses its own facilities to provide **[proprietary begin]** **[proprietary end]** of the broadband lines and **[proprietary begin]** **[proprietary end]** of the voice lines equivalents over which it offers service, with the

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<sup>7</sup> Even when the FCC permitted some measure of pricing flexibility for ILEC special access services, it made clear that ILECs remained dominant in the provision of these services and that it would continue to apply dominant carrier regulation to them. See *Access Charge Reform et al.*, Fifth Report and Order, 14 FCC Rcd 14221 ¶ 151 (1999). Similarly, the FCC found that "competitive deployment of stand-alone DS1-capacity loops is rarely if ever economic" and that "competitive deployment of DS3 loops is in some cases economic." See *Unbundled Access to Network Elements et al.*, Order on Remand 20 FCC Rcd 2533 ¶ 166 (2005). The Commission concluded that CLECs must often, if not always, rely on ILECs for these facilities.

<sup>8</sup> Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). The 1996 Act amends the Communications Act of 1934, 47 U.S.C. §§ 151 et. seq.

remainder being supplied by the ILEC.<sup>9</sup> Moreover, these statistics understate Time Warner Telecom's reliance on ILEC local transmission facilities because Time Warner Telecom deploys its own loop facilities to serve only those customer locations with large demands for broadband or voice service. Most customer locations lack sufficient demand to permit Time Warner Telecom to construct its own loops. Nationwide, Time Warner Telecom relies on ILEC loops to serve approximately 73% of the building locations of its customers.<sup>10</sup> These figures clearly indicate that, despite substantial investments in its own facilities,<sup>11</sup> Time Warner Telecom still remains heavily dependent on access to AT&T and BellSouth to serve its customer base.

17. Innovative carriers like Time Warner Telecom are particularly vulnerable to exclusionary access policies by ILECs because they need the timely availability of access services from the ILECs for which adequate regulatory safeguards do not exist. Time Warner Telecom relies on dedicated access to reach large customers and there are a variety of ways in which an ILEC can delay providing access,<sup>12</sup> can provide inferior access, or can provide access at excessive prices.

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<sup>9</sup> Based on December 2005 data filed in Time Warner Telecom's March 2006 Local Competition and Broadband Report (Form 477). Taylor Declaration (¶ 9) notes that "Wherever possible, TWTC customers connect directly using TWTC's own local fiber transmission facilities to TWTC's national IP backbone."

<sup>10</sup> See Taylor Reply Declaration, ¶ 4.

<sup>11</sup> Taylor Declaration (¶ 4) reports that Time Warner Telecom has installed 72 switches, has deployed nearly 21,000 route miles of fiber, including more than 13,000 route miles deployed in local metro networks, and has invested more than \$2.5 billion in its network.

<sup>12</sup> Annabel Z. Dodd, *The Essential Guide to Telecommunications*, Fourth Edition, Upper Saddle River, NJ: Prentice Hall, 2005 (p. 131) provides an interesting example in which *SBC IP* asked the FCC for a waiver of the requirement that it obtain telephone numbers from other carriers when it provided service in their areas, presumably because of the costs and delays involved in doing so. Ironically, *AT&T* objected to

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18. In its Petition to Deny in this proceeding, Time Warner Telecom identifies three areas in which AT&T has delayed the provision of access, has provided inferior access, or has provided access at excessive prices, and where Time Warner Telecom expects these difficulties to be exacerbated if the AT&T-BellSouth merger is approved without conditions. These areas are: (a) DS1 and DS3 local transmission facilities; (b) interconnection and the exchange of both circuit switched and IP-based traffic; and (c) Ethernet local transmission facilities.<sup>13</sup> Moreover, in its Petition, Time Warner Telecom explains why these problems are likely to be especially severe, and thus more difficult for regulators to address, as it attempts to obtain the types of facilities that it will increasingly need in order to offer innovative IP-based services.<sup>14</sup>
19. For example, Time Warner Telecom explains that AT&T has insisted, as a condition of providing special access at a discount from its high month-to-month rates, that Time Warner Telecom make a volume commitment and incur large penalties if it fails to meet the commitment.<sup>15</sup> [proprietary begin]

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SBC's request "saying this would be unfair to other VoIP providers." The FCC, In approving SBC's waiver request on a trial basis, noted that allowing SBC to avoid the need to obtain numbers from other ILECs could "foster innovation, speed the delivery of advanced services and allow carriers the opportunity to predict operational difficulties that may arise when a new network technology is deployed on a larger scale." [FCC, Order In the Matter of Administration of the North American Numbering Plan, CC Docket 99-200, Adopted: June 16, 2004, ¶ 4.]

<sup>13</sup> See Petition to Deny, pp. 34-42, and Taylor Declaration, ¶¶ 32-43, for more details on the problems faced by Time Warner Telecom in attempting to obtain needed inputs from ILECs and Taylor Reply Declaration, ¶¶ 11-15 for details on why [proprietary begin]

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<sup>14</sup> Taylor Declaration, ¶¶ 15-16 and ¶¶ 28-30, describes the importance of quality of service commitments to telecommunications customers.

<sup>15</sup> Petition to Deny, p. 15. AT&T argues that claims concerning discrimination in the provision of special access "must be raised in [the Commission's ongoing review of special access pricing and provisioning], not in this merger." (Joint Opposition, p. 92) This misses the point. It is appropriate to consider the effect

<sup>16</sup> [proprietary end]

20. With respect to access to Ethernet loops, Time Warner Telecom explains that

[proprietary begin]

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<sup>18</sup> [proprietary end]

21. As we explain below, in its current service area AT&T would have incentives to raise prices for Ethernet loops, to expand the use of other types of exclusionary behavior, and to undertake new types of exclusionary behavior, if it were to merge with BellSouth. Similarly, the merged company would have incentives to engage in the same behavior in what is now BellSouth's territory.

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of the merger on the availability of services to Time Warner Telecom and other CLECs because the merger will, by increasing the size of the footprint served by the merged entity, increase the incentive of AT&T and BellSouth to engage in discrimination in the provision of special access and, by reducing the number of benchmarks that can be used by regulators, make it more difficult to prevent such discrimination.

<sup>16</sup> [Taylor Reply Declaration, ¶ 7.]

<sup>17</sup> [Petition to Deny, p. 46, and Taylor Declaration, ¶ 41.]

<sup>18</sup> [Petition to Deny, p. 47, and Taylor Declaration, ¶ 39.]

### **3. ILECs Have an Incentive to Engage in Exclusionary Behavior**

22. Even in the absence of their proposed merger, both AT&T and BellSouth today have incentives to engage in exclusionary behavior in the provision of access services. The remainder of this section briefly examines these incentives in the absence of the proposed merger. In the next section, we explain why the proposed merger would increase these incentives.

23. Even if it did not compete downstream with other carriers, an ILEC would have incentives to exercise market power in the sale of access services. However, an ILEC has additional incentives to raise the price of, and to deny, delay or degrade the provision of, access in order to disadvantage the CLECs with which it competes in downstream markets. By denying efficient access to their rivals, ILECs such as AT&T and BellSouth are able to sustain their market power in downstream markets.

#### **3.1. Raising Rivals' Costs**

24. Rivals may be disadvantaged by both price and non-price means. One way in which an ILEC can disadvantage a rival is to increase charges for access. A firm generally benefits from an increase in its rivals' marginal costs because such cost increases raise the rivals' profit-maximizing prices and reduce their profit-maximizing output levels at current prices. Raising the costs faced by *potential* rivals may also delay or deter their entry. By charging its competitors more for local transmission facilities and for other needed access services, an ILEC can drive up the retail prices of these competitors, to its own benefit and to the detriment of consumers.

25. Moreover, by disadvantaging carriers, such as Time Warner Telecom, that also offer access services, an ILEC can also maintain its upstream market power in the provision of access services. This provides an additional reason for an ILEC to have incentives to charge wholesale access prices higher than the prices that would be set by an unintegrated monopolist of access services.<sup>19</sup>

### **3.2. Impairing Rivals' Access**

26. A second general method of disadvantaging rivals is by denying, delaying, or degrading the provision of the access needed to support the services these competitors provide to their customers. As discussed above, there are many ways in which an ILEC can disadvantage its rivals through its control of essential access services and facilities. For example, consider a carrier that wishes to offer an innovative service in competition with an ILEC. Suppose, however, that this entrant can offer the service efficiently only if it obtains a particular type of access arrangement from the ILEC. The ILEC's refusal to provide that access in a timely fashion can raise the entrant's costs or reduce the quality of its service offerings, thus limiting its ability to compete. In the extreme, the ILEC can destroy the entrant's ability to compete altogether. In either case, the ILEC will earn greater profits.

27. To the extent that regulators succeed in limiting the *prices* of access services, an ILEC will have an increased incentive to employ *non-price* means to raise rivals'

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<sup>19</sup> It does not automatically follow that any vertically integrated firm will want to disadvantage its customers in order to promote its own downstream division. The integrated firm must balance the foregone profits from lost upstream sales against the increased profits of its downstream division. Under some conditions, it will not be profitable to elevate the input price charged to downstream rivals.

costs.<sup>20</sup> The threat of non-price exclusionary conduct is particularly great against those entrants that require innovative access arrangements—arrangements that are the most difficult for regulators to monitor effectively. This type of exclusionary behavior is very difficult for policy makers to monitor, and we believe that it is impossible for policy makers fully to prevent.

28. A new entrant trying to roll out its services rapidly on a nationwide basis is especially vulnerable to ILECs' actions that delay or degrade its ability to offer the service. This is so for two basic reasons. First, the harm that the entrant experiences in one geographic area will affect its ability to compete in other areas by denying it the ability fully to exploit economies of scale and scope. Second, lowering the quality and/or raising the cost of the service that an entrant can provide in one geographic area will reduce its attractiveness to customers located in that and other areas if those customers wish to use a single carrier to serve their telecommunications needs.<sup>21</sup>

29. By engaging in non-price exclusionary conduct, AT&T and BellSouth sacrifice profits from the sale of wholesale access in return for increased power in downstream markets. The carriers also run the risk of incurring regulatory sanctions in the event

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<sup>20</sup> If access and interconnection prices were completely unregulated, the ILEC might not have the incentive to use non-price means of exclusion. This follows from the fact that increasing the price of access generates increased revenue in the upstream market at the same time that it disadvantages rivals in the downstream market. Note that in situations where price discrimination is infeasible but non-price discrimination is not, the ILEC may have the incentive to use non-price means of exclusion even when interconnection fees are unregulated.

<sup>21</sup> Taylor Declaration (¶ 25) notes that "...it is becoming increasingly important that TWTC serve a higher percentage of its Customer Locations than it has in the past. ...customers increasingly demand that carriers perform [the] network integration function and that carriers provide all of the services that a business customer needs to all of the customer's locations." See also Petition to Deny, p. 48. We note, again, that SBC claimed that its merger with Ameritech would make it a more effective competitor for customers with facilities in a number of different regions.

that regulators are able to detect and punish this exclusionary conduct.<sup>22</sup> To choose the degree to which to carry out such exclusionary conduct, an ILEC must balance the benefits of exclusion against these costs. In part, the benefits depend on the way in which the ILEC exercises the increased market power that results from exclusionary conduct.

30. In what Katz and Salop call the *relative-margin incentive*,<sup>23</sup> an ILEC enjoys increased retail unit sales at current prices if competition is weakened. Excluding its rivals permits the ILEC to replace upstream sales of *access* services to competitors with downstream sales at *retail* to end users.<sup>24</sup> If the incremental retail business that is gained is more profitable than the incremental access business that is lost, and if it is difficult for regulators to detect the exclusionary conduct, the ILEC would have incentives to exclude its rivals.

31. In what Katz and Salop call the *increased-price incentive*, an ILEC exercises the increased market power that results from its exclusionary conduct by obtaining a higher downstream price than would occur otherwise. Although, as in the case of the *relative-margin incentive*, exclusion of rivals reduces the ILEC's profits from the sale of access services, here the ILEC gains through increasing the price it can charge

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<sup>22</sup> As discussed below, the ability of regulators to detect exclusionary behavior is limited. However, the greater the extent of exclusionary conduct, the more likely it is that the ILEC will be caught and punished.

<sup>23</sup> For more details see Declaration of Dr. Michael L. Katz and Dr. Steven C. Salop, "Using a Big Footprint to Step on Competition: Exclusionary Behavior and the SBC-Ameritech Merger," October 14, 1998, filed on behalf of Sprint Corporation In the Matter of the Application for Consent of to the Transfer of Control of Licenses and Section 214 Authorization from Ameritech Corporation to SBC Communications, Inc.

<sup>24</sup> This condition is sufficient, but not necessary. Even if this scenario is not profitable at current prices, it nonetheless may be profitable to exclude a rival if AT&T increases its retail price somewhat instead of increasing its output by the full amount of the reduction in its rivals' output. For regulated services facing new competition, preventing price from falling is treated as a price increase.

downstream customers because its rivals have been weakened, even if the ILEC's output is unchanged.

32. Even if regulators capped retail prices at levels that make the *relative-margin incentive* negative, the *increased-price incentive* may still exist. Indeed, this incentive may exist even when regulators prevent the ILEC from raising retail prices because exclusionary access policies that raise or maintain barriers to entry and expansion permit the ILEC profitably to *maintain* the current (regulated) downstream price rather than *reducing* the price to meet the threat or actuality of new competition. Detering a price decrease is, of course, an exercise of market power.

33. Competing telecommunications providers obviously are harmed when an ILEC has significant market power and exercises that power by setting inefficiently high access prices or by denying, delaying, or degrading access below the efficient level. Beyond this harm to competitors, the incentives of CLECs to invest in R&D and physical infrastructure needed to provide these competitive services are reduced. Moreover, the costs of retail services will be increased, which can be expected to raise the retail prices paid by consumers, thus reducing consumer welfare below efficient levels.

34. In light of the welfare-reducing effects of exclusionary conduct, there is a public interest in limiting such behavior. This is, however, very difficult for regulators to do for two fundamental reasons. First, regulation can only imperfectly detect and prevent such conduct, particularly for new and innovative forms of access. Second, the potential for continued consolidation of the large ILECs will further reduce policy makers' ability to exercise effective oversight.

35. AT&T and BellSouth have claimed that, even if there were problems with the potential exercise of market power, regulatory oversight could sufficiently handle any potential problems.<sup>25</sup> We believe that this is not the case even for the provision of “plain vanilla” access, where policy makers have built up experience over a number of years in detecting and addressing problems and where the development of performance standards has been facilitated by the ability to employ regulatory benchmarking, whereby the performance of one ILEC is judged in comparison with the performance of others. It is certainly not the case for access that is needed to support new services.
36. Both market participants and regulators have little experience with how arrangements for new services will work under commercial conditions. Moreover, as entrants launch new services, they will need a variety of innovative access arrangements. For these arrangements, policy makers do not have the benefit of long experience in detecting and correcting problems nor have they had the time to develop comprehensive performance standards. Further, in such cases, the information needed to regulate ILEC behavior may be extremely difficult to obtain. How, for

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<sup>25</sup> See, for example, Merger of AT&T and BellSouth, Description of Transaction, Public Interest Showing and Related Demonstration, filed with the Federal Communications Commission, March 31, 2006, at 118. (“There is no longer any basis for concerns that [ILEC] discrimination would be difficult to detect. Sections 251 and 271 are now ‘fully implemented,’ and regulators and the industry have many years of experience with those arrangements. Further, as a result of the section 251 and section 271 proceedings, BellSouth and AT&T are subject to comprehensive ‘performance standards’ and self-executing remedy plans that ensure continued compliance with section 251 in all of their incumbent states.”). See also Merger of SBC Communications Inc. and Ameritech Corporation: Description of the Transaction, Public Interest Showing and Related Demonstrations, filed with the Federal Communications Commission, July 24, 1998, at 90-91. “Within SBC’s or Ameritech’s regions, the merger will not in any way alter or diminish the ability of others to compete in local exchange markets. Neither competitors, state commissions nor this Commission will allow any backsliding in the market-opening process.”

example, would the regulators determine that an ILEC was leaving unused (or underused) equipment in a central office in order to block CLEC collocation? And what sort of rules should govern whether ILECs should be required to provide tag stacking or to comply with class of service and quality of service requirements for IP traffic? In addition, as discussed in more detail below, the merger will make benchmarking more difficult by reducing the number of ILECs and distorting their incentives. For all of these reasons, if the merged AT&T-BellSouth refused to provide efficient new access arrangements, or delayed or slowed deployment of those arrangements, or reduced the quality of access below the efficient level, regulators would face significant difficulties in detecting these distortions and inducing the merged entity to correct its misbehavior.

37. Exclusionary behavior by ILECs threatens the introduction of new services by Time Warner Telecom and other carriers. Long, drawn-out litigation and regulatory proceedings will not resolve the issues soon enough to facilitate rapid entry and expansion. This is unfortunate, because such entry would help to bring increased competition to many telecommunications markets. Although policy makers should not give up trying to limit exclusionary conduct through direct oversight, it is important to ensure that competitive market forces can be used wherever possible. It is equally important that market conditions not be allowed to deteriorate in ways that increase the incentive and ability of ILECs to exercise market power.

#### **4. The Proposed Merger Would Increase AT&T's and BellSouth's Incentives and Ability to Engage in Exclusionary Behavior**

38. In light of the strong network effects and the ILECs' dominant position as providers of access services, the provision of access services by ILECs to other carriers under reasonable terms is essential to the ability of rivals to compete effectively. Although AT&T and BellSouth already have incentives to raise their rivals' costs in order to achieve, maintain, or enhance market power in the provision of local exchange and other services, their proposed merger would increase these incentives.
39. The basic logic underlying this anticompetitive effect of the proposed merger is straightforward. In many instances, rival carriers require access from multiple ILECs in order to compete efficiently. The merger of two ILECs increases their incentives and ability to foreclose competing carriers from access to their networks because it allows each of the ILECs to capture the anticompetitive benefits that spill over to the other.

##### **4.1. Out-of-Region Incentives**

40. When a competing carrier's ability to serve customers depends upon its ability to obtain efficient access arrangements at reasonable prices from multiple ILECs, the degradation, delay, or denial of access in one ILEC's region may weaken the competing carrier in the region of other ILECs. Because of these multi-market effects, one ILEC's exclusion of competitors from efficient access will anticompetitively benefit other ILECs. Thus, for example, BellSouth may currently

derive a benefit from AT&T's anticompetitive conduct. Although before the merger *AT&T would have little or no incentive to take into account that benefit to BellSouth, after the merger that incentive would be significant.*<sup>26</sup> Because what had previously been spillover benefits to BellSouth would then be internal to AT&T, after the merger AT&T's incentives to engage in exclusionary behavior would be increased.

Similarly, the merger would increase the merged entity's incentives to engage in exclusionary behavior in what is currently BellSouth's region.

41. This analysis predicts that the merger of AT&T and BellSouth would lead the merged entity to search for new methods to exclude competitors and to intensify its exclusionary conduct. This may mean more significant denials of access in both the AT&T and BellSouth service areas, further delays in granting access, and ultimately lower quality access than would have been provided in the absence of the merger. The fact that AT&T and BellSouth may today have incentives to exclude competitors does not alter this conclusion. Worsened incentives will mean more exclusion as each part of the merged firm is willing to accept a greater risk of regulatory sanctions in return for the increased rewards from successful exclusion.<sup>27</sup>

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<sup>26</sup> We understand that AT&T currently has facilities in BellSouth's service area and so would benefit in that area if AT&T's exclusionary behavior in its own service area adversely affected the ability of Time Warner Telecom and other CLECs to compete in BellSouth's service area. However, as AT&T notes, its facilities in BellSouth's service area are limited, so this effect is likely to be very small.

<sup>27</sup> In principle, the increased benefits from greater exclusionary behavior could be offset by increased regulatory sanctions in the event that exclusion is detected. However, state regulators in (say) Texas are unlikely to bring sanctions against AT&T for exclusionary conduct towards CLECs in (say) Florida or Georgia. Nor has the Commission shown any inclination to increase regulatory sanctions in response to previous mergers. Moreover, even if this scenario were plausible, there are offsetting effects. In particular, AT&T may have economies of scope in defending itself from such charges in multiple state proceedings. And, even if there is a chance of sanctioning AT&T, disadvantaged entrants may not be willing to wait around for the outcome of the proceedings. In any case, the whole point of encouraging CLEC entry is to

42. As a result of this increase in exclusionary conduct, rival carriers will be injured and will become less formidable competitors to the ILECs than they otherwise would have been. Consumers also will be harmed as competition is weakened. Prices likely will be higher, service qualities lower, and choices more limited, leading to reduced consumer welfare. To the extent that the disadvantaged competitors would offer differentiated products, or would have lower costs or higher service quality than the ILECs, the harm to consumers will be further magnified.
43. Even if exclusionary conduct in one market does not deter the entry of CLECs altogether, it may lead the CLECs to enter with higher prices or reduced service offerings and/or at lower scale. In any event, the CLECs will be less of a competitive threat to the merged ILECs.

#### **4.2. Multimarket Effects**

44. There are basically two ways in which multimarket effects can occur. First, when an ILEC engages in exclusionary behavior in its own region, it may *raise the costs* that Time Warner Telecom and other CLECs incur in other regions. If, for example, Time Warner Telecom enjoy economies of scale and AT&T engages in exclusionary behavior in supplying access to Time Warner Telecom, AT&T's actions will weaken Time Warner Telecom's ability to offer services in BellSouth's region as well.
45. Second, an ILEC's exclusionary behavior may *reduce the demand* for the services of Time Warner Telecom and other CLECs. This can occur, for example, if some

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reduce the need for regulation over time; it is not to expand the need for regulation by permitting mergers that enhance the ILECs' incentives to exclude.

customers have locations in more than one region but wish to obtain all, or a large portion of, their telecommunications services from a single supplier. Here, if AT&T were to reduce the quality of service that Time Warner Telecom can provide in AT&T's region, Time Warner Telecom will become less competitive in serving customers with locations in both the AT&T and BellSouth regions, thus providing benefits to BellSouth as well.

46. Even if multiple local markets are geographically distinct, CLECs such as Time Warner Telecom will incur common research, product development, supporting software development, and promotional costs. In deciding whether to enter specific local markets, Time Warner Telecom will evaluate its overall expected profits from entry. Thus, it would take the sum of its expected market-specific profits across all of the areas that it is contemplating entering and compare this sum with the development and other common costs. Entry will be unattractive if the market-specific profits are less than the common cost plus the required return on capital. Thus, an ILEC's actions that reduce the profitability of entry in one region can lower the likelihood, or the scale, of entry by Time Warner Telecom in all regions.

47. Exclusionary actions also may reduce the speed with which Time Warner Telecom finds it profitable to enter local markets in an ILEC's region or the extent to which it finds it profitable to make investments that improve its service quality. If the exclusion reduces Time Warner's potential customer base in the first region, this reduces its rate of return on investments. For example, suppose that a contemplated investment in product quality would allow Time Warner Telecom to increase the

number of subscribers that would be attracted to its service. If its potential customer base is reduced by exclusionary conduct in the first region, then fewer new customers can be obtained and it would earn a lower return on that investment. As a result, the investment may not earn a large enough return to justify undertaking it. In that case, potential new customers in the second region would also be denied the quality improvement, so that Time Warner Telecom would not be able to expand there either. Thus, the ILEC in the second region will gain from the exclusionary conduct of the ILEC in the first region.

48. There also may be economies of scope associated with offering service in multiple local markets that affect variable costs (*e.g.*, reduced costs of obtaining certain types of carrier equipment whose use varies with the number of subscribers or traffic volume). In this case, exclusion that reduces an entrant's volume in one market increases the entrant's variable costs in both that market and the other markets in which it is competing.

49. If, in order to compete effectively, rivals require the inputs from two ILECs that propose to merge, the merger increases both ILECs' incentives to foreclose rivals from interconnection and access to inputs by allowing each to "internalize" the benefit that it provides to the other. A merger overcomes the coordination problem that two independent ILECs would otherwise have. Thus, we would expect that a merger would lead AT&T and BellSouth to attempt a greater degree of exclusion than they would attempt independently before the merger.

50. The merger of AT&T and BellSouth may also increase their *ability* to engage in exclusionary conduct that raises rivals' costs in three ways. First, regulators will no longer be able to monitor, detect, and prove the existence of exclusionary conduct by AT&T by using BellSouth's conduct as a benchmark, or vice versa. Second, after the merger, AT&T and BellSouth may gain the ability to coordinate and rationalize their exclusionary conduct to make detection and proof more difficult.<sup>28</sup> Finally, AT&T may benefit from economies of scope in fighting regulatory battles in a number of different states.<sup>29</sup>

51. Coupled with the fact that AT&T's and BellSouth's incentives to exclude also increase, the conclusion is clear: A merger between AT&T and BellSouth would increase the magnitude of the exclusionary access problem and thereby harm consumers and competition.

52. Finally, as noted above, there may be "demand side" exclusionary effects. These occur when customers that have operations in regions served by different ILECs wish to obtain their telecommunications services in these regions from a single carrier. To the extent that exclusionary behavior by an ILEC makes it difficult for Time Warner Telecom to offer timely, high-quality service in that ILEC's region, these customers will be less willing to purchase services from Time Warner Telecom. Thus, just as in the case where exclusionary behavior in one region raises Time Warner Telecom's

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<sup>28</sup> While AT&T and BellSouth emphasize the possible sharing of "best practices" post-merger, they may well share "worst practices" (from a public interest perspective) too.

<sup>29</sup> In addition, to the extent that state proceedings do not take place simultaneously, AT&T can gain a reputation among entrants as a firm that excludes rivals, and thereby may deter the entrants from attempting to enter in the first place, or it may slow their entry plans.

*costs in another, exclusionary behavior in one region may reduce the demand that Time Warner Telecom faces in another. This produces benefits not only to the excluding ILEC but to other ILECs, as well. What would largely be external benefits to AT&T prior to a merger with BellSouth – reduced demand for the services of Time Warner Telecom in BellSouth’s territory – would be taken into account by AT&T after such a merger.*<sup>30</sup>

#### **4.3. AT&T’s Larger Footprint Would Increase Its Incentives and Ability to Engage in Exclusionary Behavior with Respect to Time Warner Telecom**

53. AT&T or BellSouth is the predominant ILEC in 22 of the 44 Metropolitan Statistical Areas (MSAs) in which Time Warner Telecom operates.<sup>31</sup> The scope of AT&T’s and BellSouth’s ILEC service territories can be illustrated by the percentage of interstate switched access minutes that Time Warner Telecom originates or terminates in the AT&T and BellSouth ILEC territories. In **[proprietary begin]** **[proprietary end]** of these MSAs, Time Warner Telecom originated or terminated **[proprietary begin]** **[proprietary end]** of its interstate access minutes of use in 2005 in either the AT&T or BellSouth service territory. In the **[proprietary begin]** **[proprietary end]** other MSAs where Time Warner Telecom operates and either AT&T or BellSouth is the predominant ILEC, Time Warner Telecom originated or

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<sup>30</sup> As we noted above, AT&T currently has only a limited presence in BellSouth’s service area, so that most of the benefits from AT&T’s exclusionary behavior in its own service area that spill over into BellSouth’s service area are “external” to AT&T.

<sup>31</sup> For a complete list of these MSAs see Time Warner Telecom, *2005 Annual Report*, p. 10. AT&T is an ILEC in portions of two other MSAs in which Time Warner Telecom operates, San Luis Obispo and Santa Barbara, where AT&T’s share of Time Warner Telecom access minutes is about **[proprietary begin]** **[proprietary end]**

terminated [proprietary begin] [proprietary end] of its  
interstate access minutes of use in the territory of one or the other of these two  
ILECs.<sup>32</sup>

54. Time Warner Telecom has [proprietary begin] [proprietary end]  
customers in the AT&T service territory and [proprietary begin]  
[proprietary end] customers in the BellSouth service territory. These figures,  
although substantial, are based only on current subscribers and thus they do not  
reflect Time Warner Telecom's ability to increase the number of customers that it  
serves in the future, which is likely to be adversely affected by an AT&T-BellSouth  
merger.
55. To obtain a rough estimate of how AT&T's merger with BellSouth would affect Time  
Warner Telecom in the future, we have calculated the increase in the proportion of  
Time Warner Telecom's *potential* market that would be served post-merger by  
AT&T.<sup>33</sup> At present, AT&T's footprint covers about [proprietary begin]  
[proprietary end] percent of addressable monthly spending in Time Warner  
Telecom's target buildings, when those buildings are defined as those that have  
demands for [proprietary begin] <sup>34</sup> [proprietary end]  
When MSAs served by BellSouth are added to AT&T's footprint, this figure becomes  
about [proprietary begin] [proprietary end] percent, an increase of about

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<sup>32</sup> These data were provided to us by Time Warner Telecom from its carrier billing system.

<sup>33</sup> See Taylor Declaration, ¶ 23, for a brief description of the methodology used by GeoResults to estimate the potential business telecommunications market in each metropolitan area.

<sup>34</sup> This calculation ignores target buildings in San Luis Obispo and Santa Barbara.