position—that telecommunications markets are so competitive that AT&T and BellSouth have neither the ability nor the incentive to foreclose entrants—above. We now examine the second reason given by AT&T and BellSouth for the diminished importance of benchmarking is that the requirement that is imposed on ILECs–that they treat rivals at least as well as they treat themselves or their affiliates, together with the associated payment of damages if they fail to do so—eliminates their incentive to behave anticompetitively.

104. AT&T and BellSouth argue that "...the relevant comparisons are between the ILEC's performance in providing service to itself and its performance in providing service to others - *i.e.*, parity standards."[79] What this claim fails to recognize is that achieving parity is not the same as cooperating with rivals. This is most obvious in the case where an entrant wishes to provide a retail service that the ILEC does not itself provide. In this case, "parity" would not require any cooperation by the ILEC. In employing the parity standard, the ILEC could either deny the wholesale service to the entrant by refusing to provide the service at retail, or delay offering the wholesale service until it has its own retail offering ready to market. In either case, the entrant would lose the advantage of early entry. Thus, the parity standard is

[79] Joint Opposition, p. 106. The same claim is made in the Joint Declaration of William L. Dysart, Ronald A. Watkins, and Brett Kissel (henceforth "Dysart Declaration"): "...AT&T complies with the parity requirements of [Section 272 of the Communications Act of 1996] in the provisioning of special access."(¶5) and "Using these data, both regulators and carriers unaffiliated with AT&T can readily determine whether the timeliness of AT&T's performance for the seven metrics for nonaffiliates as a whole is at parity with its performance for itself and its affiliates (including the Section 272 affiliate)." (¶ 36)

least likely to be useful where entrants wish to offer innovative services to their subscribers.[80]

105. The point that parity standards cannot be complete substitutes for benchmarks has often been made by the Commission. For example, in its Kansas/Oklahoma Section 271 Order, the Commission observed: "Where no retail analogue exists to compare SWBT's performance towards competing carriers to SWBT's performance to its retail operations, we evaluate SWBT's showing to ascertain whether SWBT affords competing carriers a meaningful opportunity to compete. As a result, *we sometimes rely on performance measurements that use a benchmark instead of a parity standard.*"[81]

106. In their Joint Opposition, AT&T and BellSouth observe that: "Although AT&T hopes to expand this [wholesale Ethernet] service and attract customers like TWTC, AT&T currently sells very little of this relatively new OPT-E-MAN services on a wholesale basis to retail Ethernet providers."[82] In this case, regulators must decide whether, in light of the AT&T's paucity of experience with this service, the limited amount of this wholesale service that AT&T is apparently offering is reasonable, or

---

[80] Even where the ILEC offers the wholesale service to itself, the parity standard may fail to protect entrants, notwithstanding compensation the ILEC is required to make to entrants when it provides services that are inferior to those that it provides to itself. The reason is that an entrant that obtains poor wholesale service from an ILEC—say a service that involves long delays in provisioning—will develop a reputation for poor retail service among potential subscribers. In such cases, payments provided to entrants for actual instances of poor performance will fail to compensate them for the profits they would have earned from subscribers that they would have attracted but for their reputation for poor retail service.

[81] *Joint Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma*, Memorandum Opinion and Order, 16 FCC Rcd 6237 (2001), footnote 514, emphasis added.

[82] Joint Opposition, p. 99.

whether it is the result of anticompetitive behavior by AT&T -- for example, unreasonably high prices or degraded service -- that is designed to handicap the entry of competing suppliers of retail Ethernet service. In reaching its decision, an extremely useful piece of information for regulators to have would be whether other ILECs are offering the service to CLECs. Significantly, Time Warner Telecom has been able to point out in this proceeding that the terms on which it can obtain access to wholesale Ethernet services **[proprietary begin]**

[83]] **[proprietary end]**

107. In their Declaration in support of the Joint Opposition, Dysart *et al* argue: "... to the extent that opponents believe that the current performance measurements are 'obsolete', they have the right to seek new or changed measurements to reflect the new developments that they describe."[84] Although this is, of course, correct, Dysart *et al* fail to note that one of the most persuasive forms of evidence that a CLEC can offer in support of claims that current performance measurements are inadequate would be that other ILECs are achieving higher levels of performance. Thus, it is not correct, as Dysart *et al* claim, that "AT&T's reporting of performance data ... eliminates any need to 'benchmark' its performance against that of other ILECs."[85] Performance measurements are, at best, a complement to benchmarking, not a substitute for it.

[83] Taylor Reply Declaration, ¶ 10 and ¶ 28.

[84] Dysart Declaration, ¶ 53.

[85] Dysart Declaration, ¶ 51.

108. Finally, in their discussion of their negotiations with Time Warner Telecom to develop a contract tariff for Ethernet access service, AT&T and BellSouth inadvertently provide support for the need for benchmarking. They argue: "To be sure, TWTC is seeking even lower prices than AT&T has proposed and features that AT&T's service does not currently support. But these are exactly the type of issues that should be - and ... can be - resolved at the bargaining table, not in a merger proceeding."[86] What this statement fails to note is that an important way in which the Commission, and other regulators, and Time Warner Telecom itself, can judge the reasonableness of AT&T's behavior, is by comparing it to the behavior of other ILECs. By eliminating an important benchmark the proposed merger of AT&T and BellSouth would seriously diminish their ability to do so.

109. In summary, we have seen how mergers reduce the flow of information for benchmarking purposes, even if we assume away all incentive effects of the merger. Indeed, this effect has been recognized both by the Commission and by others. For instance, the Commission has noted, "[m]ergers between incumbent LECs will likely reduce experimentation and diversity of viewpoints in the process of opening markets to competition."[87]

[86] Joint Opposition, p. 99.

[87] FCC 97-286, ¶ 152.

10. Incentive Effects on Benchmarking Due to a Merger

110. A merger between firms with market power that compete in a product market has anticompetitive incentive effects that are well understood by competition authorities.[88] The "unilateral" effects stem from each merging party's incentive to help its new partner.

111. When two firms compete in a product market, each has opportunities to engage in behaviors that (a) are socially desirable, (b) are profitable for that firm, (c) reduce the profits of the other firm, and (d) therefore are less likely to take place after a merger between the firms. In the case of product-market competition, "lowering price towards marginal cost" is the paradigmatic example of such competitive behavior, although quality improvements, innovation, and other effects are also (and in some cases more) important. For this reason, antitrust authorities will challenge a merger between such firms if consumers lack adequate other alternatives, and if the change in incentives is likely to lead to significant worsening of the firms' offers to consumers.

112. When two ILECs are subject to benchmark regulation, similar economic forces are at work. The socially desirable behavior that the merged firm could undertake includes lowering access costs and accommodating the entry of CLECs. Although an individual ILEC may sometimes be willing to take such actions, those actions may harm other ILECs – by raising the average level of performance against which they are judged, by raising best practice performance, or by increasing the disparities

[88] U. S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992 (revised April 8, 1997).

among the performances of various firms. Although each ILEC will generally ignore the effects of its own behavior on other ILECs, after a merger, each merger partner will take into account the effects of its behavior on the standards that will be applied to the partner. Thus, in addition to the increased incentive of the merger partners to discriminate against CLECs because of their larger footprint, each partner also has an incentive to reduce its level of cooperation with CLECs in order not to have the same level of performance imposed on its new partner. These latter incentives worsen the comparative information available and impair average-practice, best-practice, and other forms of benchmarking.

10.1. Unilateral Incentive Effects of Merger under Average-Practice Benchmarking

113. Average-practice benchmarking sets firms into a form of competition with one another even if they do not compete in any conventional product market. As Vickers has expressed it, if two agents face a similar incentive scheme in which each agent's rewards are based both on its own and another's performance, the agents "are in competition in the sense that the reward of each partly depends on performance relative to that of the other agent."[89] The establishment of benchmarks thus creates "competition-by-comparison" between firms that do not directly compete with each other in the same geographic markets.

114. As one might expect from this observation, mergers between firms whose performance is regularly compared under benchmarking can have adverse unilateral

[89] John Vickers, "Concepts of Competition," *Oxford Economic Papers*, January 1995, Vol. 47, No. 1, p. 10.

incentive effects that are very similar to the corresponding anticompetitive effects of mergers among direct product-market competitors. Thus, consider the effect of a merger on the incentive to reduce access costs. After the merger, each of the partners in the merged firm will internalize the effect of its cost reductions on its new partner's profits. Compared to the situation before the merger, when the firms were competitors-by-comparison, this reduces each firm's incentive to lower its costs.[90]

115. If (say) AT&T lowers its recorded access costs, this will reduce average ILEC access costs, and will, under average performance regulation, require BellSouth, and other ILECs, to reduce their access prices. This will make BellSouth worse off. Post-merger, therefore, the incentive for the merged firm to reduce its access costs in the former AT&T's area will therefore be lower than the incentives AT&T faced prior to the merger. Symmetrically, BellSouth's incentive to lower costs also declines.

10.2. Unilateral Incentive Effects of Merger under Best-Practice Benchmarking

116. A merger will similarly weaken the effectiveness of best-practice benchmarking because of the adverse (unilateral) *incentive* effects of taking a merger partner's interests into account. In our analysis of this problem, we distinguish two cases: (a) the merged firm sets a common practice for both partners, and (b) the formerly independent (now merged) firms maintain two different practices. Although the analysis of these cases is somewhat different, the key themes and qualitative

[90] Although ILECs in different geographic areas are also suppliers of complements—each supplies originating access for calls terminating in the other's territory—this effect is surely small compared to the effects considered here.

result—a loss of effectiveness for best-practice benchmarking—are the same in both.

117. When the merged firm sets a common practice, that practice is likely to lie strictly between the practices that the two parties would have set separately absent the merger. As noted above, under best-practice benchmarking, only the best observation among all firms in the industry ultimately counts. Thus, either the merger makes no difference (because neither merging party would have provided that best observation), or the merger moves the firm with the best practice closer to the other partner's preferences (because the best-practice firm now internalizes the effect on its partner), which lowers the standard against which other firms are judged.

118. In some instances, the partners in the merged firm will maintain different practices. However, even in this case there is an incentive to "shade" the previously independent choice in the direction of the merger partner that is less cooperative toward CLEC entry. This is so because, after the merger, the more cooperative partner will take into account the effect of its behavior on the level of cooperation that regulators will demand of its merger partner, and will reduce its level of cooperation accordingly.

119. It is important to note that even if the merger improves the performance of the less cooperative partner, this improvement does not mitigate the impairment of the best-practice benchmark. While a merger between an ILEC that (in a particular matter) is cooperative with new competitors and one that is intransigent may moderate the behavior of both, under best-practice benchmarking it is only the

merger's effect on the cooperative ILEC that affects the final result, and that *partner's level of cooperation is likely to fall. As a result, other ILECs will be* judged against a less stringent standard in the future.

10.3. Coordinated Effects and Risk of Collusion

120. Recall from our discussion above that, under competition-by-comparison (as under product-market competition), each ILEC can undertake actions that are socially desirable and profitable but that harm the interests of other ILECs. A merger can increase the threat that a common understanding will develop (explicitly or implicitly) not to engage in such behavior. We believe that a substantial decrease in the number of relevant independent firms (and for some purposes only large ILECs may be relevant firms) can significantly increase this threat.

121. This, too, is not a novel point. Indeed, the Commission has observed that, although ILECs have a common interest in minimizing their cooperation with regulators and competitors who are seeking to open their local markets to competition, "On any particular issue ... one incumbent LEC may have an incentive to cooperate with its competitors, contrary to the interests of other LECs," an incentive that may arise from regional differences between the ILECs.[91] The Commission rightly observed that if two major ILECs merge, the incentive for an individual ILEC to "break ranks" and cooperate with pro-competitive processes may be reduced.

[91] FCC 97-286, ¶ 154.

122. As in the product-market case, such parallelism is more likely the smaller the number of large ILECs. In large part, this is because of the diversity discussed above in the context of best-practice benchmarking. That is, with many ILECs, it is more likely that there will be one or two mavericks on any complex issue. With a large number of players, an ILEC contemplating aggressively cutting costs or boldly innovating will be less inclined to worry about offending the others by breaking an otherwise united front. By contrast, as the number of ILECs is reduced by merger, they become more likely to be able to coordinate their behavior and refrain from socially desirable actions.

123. Our discussion of the use of comparative and benchmark techniques by telecommunications regulators illustrates one of the important losses from mergers among large ILECs. We note again that not only regulators but also customers and suppliers of complements (such as IXCs), as well as nascent competitors, can and do compare ILECs against one another. With only four relatively large ILECs remaining after earlier mergers, the loss of one ILEC would substantially damage efficient regulation, including the regulation necessary for the growth of competition in local exchange and exchange access markets

I hereby declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed on July 19, 2006

Stanley M. Besen

Stanley M. Besen

I hereby declare under penalty of perjury that the foregoing is true and accurate to the best of my knowledge and belief.

Executed on July 19, 2006

B Mitchell

Bridger M. Mitchell