AFFIDAVIT OF ALFRED E. KAHN AND TIMOTHY J. TARDIFF
BEFORE THE FEDERAL COMMUNICATIONS COMMISSION
In the matter of Application of SBC Communications Inc.,
Southwestern Bell Telephone Company,
and Southwestern Bell Communications Services, Inc.,
for Provisions of In-Region, InterLATA Services in Oklahoma

TABLE OF CONTENTS

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the matter of	)	
	)	
Application of SBC Communications Inc.,	)	
Southwestern Bell Telephone Company,	)	CC Docket No._____
and Southwestern Bell Communications	)	
Services, Inc. d/b/a Southerwestern Bell Long	)	
Distance for Provision of In-Region	)	
InterLATA Services in Oklahoma	)	

AFFIDAVIT OF
ALFRED E. KAHN AND TIMOTHY J. TARDIFF

Alfred E. Kahn and Timothy J. Tardiff, being duly sworn, depose and say:

I. INTRODUCTION

1. My name is Alfred E. Kahn. I am the Robert Julius Thorne Professor of Political Economy, Emeritus, Cornell University and Special Consultant with National Economic Research Associates, Inc. (NERA). I have been Chairman of the New York State Public Service Commission and of the Civil Aeronautics Board; and in my capacity as Advisor to President Carter on Inflation, I participated actively in the successful efforts of his Administration to deregulate both the trucking industry and the railroads. I am the author of the two-volume *The Economics of Regulation*, reprinted in 1988 by MIT Press, and have written and testified extensively in the area of direct economic regulation, and particularly of the railroad, trucking, airline and telecommunications industries. Of particular relevance to my

statement here, I have also been a member of the Attorney General's National Committee to Study the Antitrust Laws (1954-56) and the National Commission on Antitrust Laws and Procedures (1978-80); I am the co-author of *Fair Competition, The Law and Economics of Antitrust Policy* and have published numerous articles in that area. I attach a copy of my full resume as Appendix A.

2. My name is Timothy J. Tardiff. I am a Vice President at National Economic Research Associates. I have specialized in telecommunications policy issues for about the last 15 years. My research has included studies of the demand for telephone services, such as local measured service and toll; analysis of the market potential for new telecommunications products and services; assessment of the growing competition for telecommunications services; and evaluation of regulatory frameworks consistent with the growing competitive trends. Most recently, I have participated in interconnection arbitrations, pursuant to the Telecommunications Act of 1996, in twelve states. I attach a copy of my full resume as Appendix B.

3. SBC Communications Inc. and its subsidiaries Southwestern Bell Telephone Company ("SWBT") and Southwestern Bell Communications Services, Inc. d/b/a Southerwestern Bell Long Distance ("SBLD")—collectively, "Southwestern Bell"—seek authority for SBLD to provide in-region interLATA services in the State of Oklahoma. The purpose of this affidavit is to assess the public interest impact of such entry.

II. THE HISTORICAL TRADE-OFF IN THE LINE-OF-BUSINESS RESTRICTIONS

A. The Issue During the Pre-divestiture Period

4. The progressive introduction of competition into the telephone business, dating back to the FCC's *Above-890* decision in 1959 and to *MCI* a decade later, and AT&T's evolving responses precipitated intense controversy at the FCC, Congress, the Antitrust Division of the Department of Justice and the courts over how best to reconcile the dominant position of the comprehensively integrated Bell System, on the one side, and the evolving national policy of encouraging competition, on the other.

5. We make no effort to recount that history.[1] We think it is not an oversimplification, however, to say that once the commitment to competition was reached at the Federal level, the central issue was the extent to which *regulatory* restraints on AT&T would be sufficient to ensure fair and efficient rivalry between it and its challengers or whether, instead, it would be necessary to break up the Bell System, imposing line-of-business restrictions on the successor companies, in order to deprive them of the power and motive to frustrate achievement of that goal. In these intense debates, AT&T and its supporters in government resolutely proclaimed the benefits of the comprehensive horizontal and vertical integration of the Bell System, and its adversaries tended to minimize those asserted benefits to the point of denying their existence entirely.

---

[1] A particularly thorough history is presented by Peter Temin in, *The Fall of the Bell System, A Study in Prices and Politics*, New York: Cambridge University Press, 1987; for an account of developments and the underlying economic issues up to 1970, see Kahn, Alfred E., *The Economics of Regulation*, New York: John Wiley & Sons, 1970-71, reprinted by MIT Press, 1988, Vol. 2, pp. 126-152, 290-306.

6. What ultimately tipped the scales on the side of complete divestiture of local telephone service from the other operations of the Bell System—notably toll—was the developing view of the Department of Justice, that all the proposed protections against cross-subsidization, predation and exclusionary practices would be excessively "regulatory" and ineffective, and that only a total separation of the putatively "naturally monopolistic" local telephone service from the other potentially more competitive services would be consistent with the preservation and promotion of competition in the latter markets.

B. The Balance of Advantages and Disadvantages has Shifted

7. The terms of the trade-off between the respective benefits of integration and divestiture have changed drastically since the entry of the MFJ. In fact, whatever one's evaluation of the net advantages and disadvantages of the line-of-business restraints on the BOCs during this interval, they clearly must be reconsidered in the light of (a) the dramatically changed factual circumstances; (b) our experience with the way competition has worked in the interLATA market and increasing recognition of the important contribution that BOC entry is likely to make in intensifying that competition and extending its benefits more broadly; (c) the changes in both regulatory practice and in the market that have tended to dilute whatever power the BOCs may have had to handicap competitors; (d) the extensive experience we have actually had since 1982 with competition between the putatively monopolistic BOCs and rivals dependent upon them for essential services and (e) changes in the mix of national policies and goals articulated most clearly in the Telecommunications Act of 1996. In our judgment, all these factors have shifted the balance of the public interest—wherever it was in 1982—unequivocally over to elimination of those absolute restrictions.

8. This proposition has now been endorsed, in both general terms of national policy and in highly specific ways, by the Telecommunications Act of 1996. We have now made our choice. The Act clearly concludes that the balance of advantages and disadvantages has unequivocally shifted in favor of abandoning the line-of-business restraints of the BOCs. It remains for us only, therefore, to spell out why the public interest criterion established by the Act for elimination of the restriction on interLATA service has clearly been met.

III. SOUTHWESTERN BELL'S ENTRY IS IN THE PUBLIC INTEREST

9. Whatever may be said in its favor, the current prohibition on interLATA entry by the RBOCs is also, undeniably, inherently anticompetitive. In the name of preserving competitive opportunities for some, it prohibits others from competing entirely. The only possible justification for its continuance would be that the gains to society from protecting the former outweigh the costs of excluding the latter and that those protections could not be achieved by other means less costly to consumers. The remaining portions of this statement consist of an amplification of our reasons for concluding—as, indeed, the Telecommunications Act of 1996 itself clearly concludes—that the balance of advantages and disadvantages has unequivocally shifted in favor of abandoning the line-of-business restraints on the BOCs.

10. The costs are great. The excluded competitors are large and potent. The market from which they are excluded—a market whose boundaries have been defined entirely arbitrarily, so far as the relevant technology and economics are concerned—has distributed the benefits of rapidly improving productivity imperfectly and incompletely. The customers that have benefited disproportionately little are precisely the ones that the excluded BOCs would have the greatest comparative advantage in serving: those companies will therefore be the most

logical and effective competitors of AT&T for residential and small business services initiated within their own regions. Unlike MCI and Sprint in 1984, they already serve all of these customers. Supplying additional services to an existing customer is far easier—and less costly—than establishing a commercial identity and presence before new ones.

A. The Current State of InterLATA Competition

11. The most fundamental change in interstate long-distance markets since the 1984 divestiture and the one most relevant in the present context is that this portion of the industry is not only dominated by AT&T, MCI and Sprint, but consists exclusively (apart from a few corridor areas that were exempted from the long-distance restriction) of companies entirely separate from—indeed antagonistic to—the successor Bell Operating Companies. In addition, the rapid development and expansion of fiber-optic technology has radically altered cost structures, much as advances in microwave technology did a decade or two earlier, and contributed to a dramatic expansion—approximately a trebling—of total network capacity in just 11 years. Whereas previously there was only the one nationwide long-distance network, totally integrated with companies accounting for some 80 percent of all local service, there are now nearly four backbone long-distance networks, fully separated from the BOCs. Those four clearly do compete with one another, as well as with a large fringe of much smaller rivals, facilities-based and resellers. That competition is, however, far from fully effective; and its deficiencies are ones that competitive entry by the BOCs is most likely to remedy.

1. Long distance prices, access charges and margins, overall

12. Since divestiture, long-distance prices have declined—about 23 percent in nominal dollars and about 50 percent relative to the Consumer Price Index (CPI-U).[2] What is at least equally striking, however, is that these decreases have been more than fully "explained" by FCC-mandated decreases in the prices that the long-distance carriers pay to the local exchange carriers for access to their networks. According to the FCC, the average interstate switched access charge per conversation minute fell about 65 percent from May 1984 to May 1996.[3] This would translate to a decline of $0.11 per conversation minute. To make this reduction possible, the FCC imposed monthly subscriber line charges directly on telephone customers, shifted costs to the intrastate jurisdiction through changes in separations rules and adopted price cap formulas that mandated reductions over time in the remaining local exchange carrier interstate carrier access revenue requirements.

13. According to a recent estimate, therefore, AT&T's annual carrier access bill dropped by about $10.3 billion between 1984 and 1994 (holding volumes constant, in order to reflect the pure change in price), while over the same period of time the bills that its customers received fell by about $8.5 billion (once again holding volumes constant). Thus, despite massive competitive advertising and the active competition for large business customers to which it was

---

[2] As measured by the consumer price index for interstate long-distance. U.S. Department of Labor, Bureau of Labor Statistics, Office of Publications, Division of Information Services.

[3] Federal-State Joint Board Staff, *FCC Monitoring Report*, May 1996, Table 5.11, p. 474.

subjected in the interstate long distance markets, AT&T was still able to raise its prices relative to access charges and collect an additional $1.8 billion per year.[4]

14. The contrast between the changes in access charges and prices since 1994 have become even more striking: while access charges have continued to fall, prices have risen. Access charges per conversation minute have decreased by about 10 percent since January 1994.[5] Simultaneously, AT&T has increased the basic rate for residential interstate calling by over 20 percent.[6] Obviously since 1994 basic rates and access charges have not changed to the same degree—they have not even changed in the same direction. Indeed, during 1996 alone, interstate toll prices (as measured by the CPI-telephone, interstate) increased by 3.7 percent—substantially more than the 2.9 percent rate of increase in the CPI).[7]

15. The long-distance carriers have strongly criticized the high charges they typically have to pay the LECs for access to their networks. Those charges have indeed been set by regulators far above cost, deliberately, in order to perpetuate the subsidy that had, before AT&T was split up, flowed from similarly inflated long distance charges to hold down the rates for basic residential service. By any measure, however, AT&T's own average markups above those

---

[4] Taylor, William E., "Competition in the Interstate Long-Distance Markets: Recent Evidence from AT&T Price Changes," filed in CC Docket No 94-1 (March 1995), pp. 4-5. We emphasize that the evidence we present here is of the change in prices alone, for given volumes of usage. This is not the same as average revenue per minute.

[5] Federal-State Joint Board Staff, *FCC Monitoring Report*, May 1996, Table 5.11, p. 474.

[6] In the price hike of January 1994, basic residential rates rose by an average of 6.3 percent ("AT&T Proposes $750 Million Rate Hike, New Calling Plan Aimed At High-Volume Residential Users," *Telecommunications Reports*, January 3, 1994). Rates further increased in December 1994 by 3.7 percent ("AT&T and Rivals Boost Rates Further," *Wall Street Journal*, November 29, 1996, p. A3). Following a year of no rate increase in 1995 as it had promised ("AT&T Proposes Consumer Price Changes, Discounts," *Telecommunications Reports*, February 20, 1995), AT&T put into effect a basic rate increase of 4.3 percent and 5.9 percent in February and December 1996, respectively ("AT&T Follows MCI, Sprint with Long Distance Rate Increases," *Telecommunications Reports*, December 2, 1996).

access charges and above its own long-run incremental costs continue to be larger than the markups in the access charges themselves.

16. In 1994, for example, AT&T's reported revenue per minute averaged 18 cents; its reported carrier access payments averaged 6 cents per (conversation) minute.[8] Incremental toll costs are estimated at 1 - 2 cents per minute[9] and carrier access incremental costs at half that level or less (per conversation minute).[10] Thus, while a group of economists assembled by AT&T are correct in asserting that

> (i)f there is one factual issue in the telecommunications industry upon which there is virtually unanimous agreement, it is that carrier access services are currently priced well in excess of their incremental costs[11]

they are wrong in their selectively pejorative treatment of those particular prices. While the LECs mark up their carrier access prices over incremental cost by (say) a nickel, AT&T marks up long distance prices over incremental cost by a dime. Thus the AT&T economists are wearing blinders when they condemn the former markup as a "regulatory-sanctioned pricing distortion"—"clearly an anathema to economic efficiency," with cumulative social costs "certain

---

[7] U.S. Department of Labor, Bureau of Labor Statistics, Office of Publications, Division of Information Services.

[8] AT&T *ex parte* letter in CC Docket No. 94-1, March 21, 1995.

[9] Perl, Lewis J. and Jonathan Falk, "*The Use of Econometric Analysis in Estimating Marginal Cost*," Presented at Bellcore and Bell Canada Industry Forum, San Diego, California, April 6, 1989, Table 2. See also Crandall, R.W. and L. Waverman, *Talk Is Cheap*, Washington: Brookings, 1996, p. 92.

[10] AT&T economists cite incremental costs of carrier access between 1/3 and ½ cents per minute (at 27). They are silent on the question of long distance incremental costs. D. Kaserman, J. Mayo, M. Crew, N. Economides, G. Hubbard, P. Kleindorfer and C. Martins-Filho, "Local Competition Issues and the Telecommunications Act of 1996," prepared on behalf of AT&T, July 15, 1996.

[11] *Ibid*., p. 26

to run into the billions of dollars per year" (at 27)—while AT&T itself extracts roughly twice that markup per minute in its own retail toll rates, in a market it claims to be fully competitive.[12]

2. Distribution of the benefits of competition between large and small users

17. Large business customers have benefited greatly from the new competition in the long distance business. The combination of the large volume of their business, on the one side,

[12] Our contrast between the apparent markups above incremental cost contained in the carrier access charges of the ILECs, on the one side, and AT&T's toll rates, on the other, is of course sensitive to the estimate we employ for the LRIC of the latter operations. Since we now have an explicit estimate of the "long-run incremental costs of long-distance" of "between $0.03 and $0.08 per minute (including sales and administrative costs)," by Crandall and Waverman (*op.cit.*, p. 181), it seems desirable to take this later estimate into account in attempting to put these two respective markups in perspective.

To this end, we make the following additional observations:

- Our 2 cents per minute figure was the top of the 1 to 2 cents range estimated by Perl and Falk.
- In making the first of their welfare-loss calculations, Crandall and Waverman themselves allude to their "assume[d] 2 cents per minute" incremental cost (p. 92, stress supplied), which they then refer to in an attached footnote as "our 2 cent per minute estimate" (p. 94, stress supplied). And in their conclusory chapter, they say that "the incremental costs of long-distance service is probably no more than 5 cents and surely no more than 10 cents per minute" (pp. 276-77), citing the Company's reported marketing and customer service and general and administrative costs, which they take to be on the order of 3.9 cents and 2.9 cents per minute (p. 142), respectively. While a large portion of the former costs are probably part of the Company's TSLRIC (as contrasted with the LRIC of smaller increments), it seems highly unlikely that that would be true also of the general and administrative costs.
- In any event, the authors' assertion that "it [would be] unwise to estimate AT&T's marginal costs as simply 1 cent per minute over and above access costs and conclude the prices should fall to this level" (p. 144) is based on the proposition, with which we are in total agreement, that prices would have on average markedly to exceed incremental costs even in competitive equilibrium—that is, if total forward-looking costs were to be recovered—a proposition that applies equally to the ILECs.
- We observe, only in passing, that Paul W. MacAvoy uses an estimate of LRIC for long-distance calling at 1 cent (*The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Services*, MIT and AEI Presses, 1996, p. 115), citing an estimate by Wharton Econometric Forecasting Associates and that a recent report by Lehman Brothers (*Telecom Services: Buy the Bundle Builders, Get the Growth*, March 18, 1996, p. 28) includes an estimate of long-run incremental cost: "Large customers and large resellers can purchase transport at close to long-run incremental costs, or at about the $0.02 per minute in average depreciation and network engineering costs of the major players (this is the rate that the federal government recently negotiated on its multiyear FTS 2000 contract for POP-to-POP transport)." It seems likely, however, that these figures fail to include such marketing, customer service and overhead costs as would indeed be properly part of the LRIC of the total service.

If, then, we were to have employed the Crandall-Waverman estimate of the "probable" ceiling of 5 cents per minute, our comparison would show AT&T marking up its retail long-distance prices on average by at least 7 cents above incremental cost plus access, compared with the 4 cents by the LECs that has so bitterly offended its economists.

and, on the other, the very wide gap between the incremental costs of the IXCs and their average rates has forced the IXCs into intense competition in offering special contractual arrangements, incorporating both special prices and new and superior service offerings. As the FCC has observed, large customers now solicit proposals from multiple vendors and negotiate terms directly with the interexchange carriers.[13]

18. The price reductions have been dramatic: the average cost for a minute of long distance service for a large corporation appears to have fallen by about 80 percent (nominally, and even more in inflation-adjusted dollars) since 1983. [14] Prices in 1983 were at about 35 cents per minute and are now at about 7 cents per minute for the largest business customers.[15]

19. Small residential subscribers have not benefited to anything like the same degree. In contrast with the estimated 80 percent decline for large business customers, long distance prices for residential consumers (as measured by the CPI) declined by about 29 percent from 1984 through the beginning of 1994. Since AT&T reported an average revenue per minute (ARPM) for its Consumer markets of about 23 cents in 1994,[16] this means its average residential long distance prices fell about 9 cents per conversation minute during the preceding decade—while access charges declined 11 cents.

---

[13] Report and Order, In the Matter of Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, FCC, 6 FCC Rcd. 5880, 5887, Adopted: August 1, 1991, Released: September 16, 1991, par. 38.

[14] Felix, Michael T., "Preparing the Market for Enhanced Service Implementation," *Telephony*, Vol. 230, No. 13, March 25, 1996, p. 40.

[15] Rohde, David, "VPN Rates On The Way Down," *Network World*, December 2, 1996, Vol. 13, No. 4g, pp. 1, 14-15; Table 7.12, *Statistics of Communications Common Carriers*, Federal Communications Commission, 1988/1989 Edition, p. 286; Felix, "Preparing the Market...," *Telephony*, p. 40; Crandall & Waverman, *Talk Is Cheap*, 1993, p. 125; "GSA Tells Congress FTS 2000 Prices Beat Market Rates," *Telecommunications Reports*, March 8, 1993.

20. The apparent 2 cents per minute increase in residential rates net of access charges in the first post-divestiture decade evidently grew in the next two years: since 1994, AT&T has increased the basic rate for residential interstate calling by over 20 percent. Its price hike of January 1994, by an average of 6.3 percent, was targeted at low-volume subscribers as well as ones under AT&T's residential calling plans indexed to the basic rate.[17] It increased rates further by 3.7 percent in December 1994,[18] and 4.3 percent and 5.9 percent, respectively, in February and December 1996.[19] These increases over the last two years have occurred in the face of a continued drop in carrier access charges—by almost 10 percent—during the same period.[20]

21. We must of course consider the possibility that this dramatic difference in the trend of long distance charges to large business and small residential customers represented a correction of a previous distortion—specifically, a cross-subsidization of the latter rates at the expense of the former—such as would be expected to take place with the introduction of effective competition. This is the claim of Bernheim and Willig—that the costs per minute of serving low-volume customers is significantly higher than of serving high-volume ones because

---

[16] Ex Parte Presentation in Support of AT&T's Motion for Reclassification as a Nondominant Carrier, Attachment I, Letter from C.L. Ward, AT&T, to William F. Caton, FCC, dated February 8, 1995.

[17] "AT&T Proposes $750 Million Rate Hike, New Calling Plan Aimed At High-Volume Residential Users," *Telecommunications Reports*, January 3, 1994.

[18] Keller, John J., "AT&T and Rivals Boost Rates Further," *The Wall Street Journal*, November 29, 1996, p. A3.

[19] "AT&T Follows MCI, Sprint with Long Distance Rate Increases," *Telecommunications Reports*, December 2, 1996.

[20] Access charges per conversation minute have declined by 9.34% (from 6.66 cents to 6.04 cents) since July 1993, although there occurred a brief intervening increase from 6.66 cents to 6.89 cents, or about 3.4%, in July of 1994. (See Table 5.1 in *FCC Monitoring Report*, May 1996, p. 474.)

of the presence of fixed customer costs, such as billing, collections, fraud and customer service, that do not vary with usage for any given subscriber.[21]

22. For purposes of testing this possible justification of the increase in AT&T's long-distance charges, net of access fees, to small residential users, we use the Company's own definition of low-volume residential customers as ones with long distance charges of $10 per month or less: these are the people who pay the basic rates that have been subject to the recent increases.[22] AT&T says that more than half of its customers fall in this category. It also asserts that customers with average monthly bills under $3 are below the "break-even point."[23] This claim suggests that, to the extent these last customers can be segregated, rates charged them would indeed be expected to increase under real-world competitive conditions, even though presumably the marginal costs of their long-distance calling would be no higher than for higher-volume customers.[24] But it would neither explain nor justify the increases in basic usage rates undiluted by discount offerings that at least half of residential users have been forced to pay, on grounds of either average cost per customer or marginal cost of usage: the group in the $3 to $10 per month range, with four times the usage of the ones below AT&T's claimed $3 break-even point, must be making a very large contribution to company profits.

---

[21] Bernheim, B. Douglas and Robert Willig, "An Analysis of the MFJ Line of Business Restrictions," December 1, 1994. Attachment G, Ex Parte Presentation in Support of AT&T's Motion for Reclassification as a Nondominant Carrier, CC Docket No. 79-252, April 20, 1995.

[22] Letter of C.L. Ward to W.F. Caton Dated March 9, 1995 Re: Ex Parte Presentation CC Dockets Nos. 79-252, 93-197, 80-286; Quinn, D.J., *The Light User Segment of the Long Distance Market*, March 8, 1995, p. 8.

[23] *Ibid*.

[24] That is to say, under theoretically pure competition, under which rates for usage would be held to marginal (usage-sensitive) costs, the higher average costs of the very low-volume users would not be reflected in usage rates higher than those charged heavier users. Since, however, the former particular customers would in those circumstances not be worth serving at all in these circumstances, providers of long-distance service to them

23. The only possible explanation for their having fared so much less well under competition than large business customers is that the concentrated oligopoly of long-distance carriers serving them has found it easier to resist the temptation to engage in price competition for their patronage than for that of the big users. We observe repeatedly in AT&T's pricing behavior the kind of price leadership that denies low-volume customers the full benefits of competition, once the adoption of alternative regulation permitted it to increase its basic rate schedule.

B. The Benefits of Southwestern Bell's Entry into the InterLATA Market

24. The FCC, having previously expressed "serious concern" about the apparent pattern of price leadership that had emerged in the long-distance business,[25] has recognized that "the Act provides the best solution to any problem of tacit price coordination...by allowing for competitive entry in the interstate interexchange market by the facilities-based BOCs...."[26] Southwestern Bell's entry will promote effective competition by reducing the ability of the IXCs to engage in such quasi-collusive pricing at the expense of small residential customers. It will have this effect not merely because it will increase the number of large, well-positioned competitors in its region by one; more important, it will introduce a large competitor that (a) begins with a zero market share, (b) is, by virtue of the likely large volume of its purchases, in a

---

would have to be compensated for the fixed per-customer costs either by levying a flat charge on them or by finding a way of charging them discriminatorily higher rates for usage.

[25] Order, In the Matter of Motion of AT&T to be Reclassified as a Non-Dominant Carrier, Federal Communications Commission, FCC 95-427, Adopted: October 12, 1995; Released: October 23, 1995; par. 81-83.

[26] Notice of Proposed Rulemaking, In the Matter of Policy and Rules Concerning the Interstate, Interexchange Marketplace Implementation of Section 254(g) of the Communications Act of 1934, as amended, CC Docket No. 96-61, Federal Communications Commission, 11 FCC Rcd 7141; 1996 FCC Lexis 1472, FCC 96-123, Adopted: March 21, 1996, Released: March 25, 1996, par. 81, footnote omitted; emphasis added.

particularly strong position to take advantage of the large excess transport capacity of the present market-dominating IXCs[27] and (c) has cost characteristics and (d) a current mix of services uniquely promising to remedy the single greatest deficiency in the performance of the long-distance market.

25. While they would be a powerful market presence within their respective LATAs from the outset, they would begin interLATA competition with a zero market share—much like the competitive position of the interexchange carriers when they were permitted to offer service within the LATAs; they would have to offer attractive prices to break into that market. That zero market share of course also refutes the FCC's apparent notion that the BOCs have a "dominant" position in the interLATA market.

A more effective competitor

26. There are of course already hundreds of resellers of long distance service. Typically purchasing these services from an underlying facilities-based carrier under long term contracts, such as AT&T's contract tariffs or Tariff 12 options, they have mainly targeted business customers with monthly long distance bills of several hundred dollars. While Southwestern Bell Long Distance is considering some facilities, it will likely first provide services on a resold basis, because the current capacity of the combined interLATA networks is sufficientlylarge to meet immediate needs. Southwestern Bell's affiliate is well positioned to be highly effective both in obtaining underlying services from IXCs and more effective in reaching small customers.

[27] FCC 95-427, par. 57-62.

27. The present resellers have been disadvantaged by lack of a strong brand name. They have therefore had to rely heavily on direct personal approaches and negotiations, which are unlikely to be economical in soliciting the business of low-volume users. Southwestern Bell, in contrast, already serves those customers and has a strong established brand name.

28. At the buying end, the BOC affiliates are likely to be able to negotiate much more favorable terms with the IXCs than the present resellers, because of the large volumes of purchases to which they are likely to be able to commit themselves. (And of course volume discounts at favorable prices are a common phenomenon across the entire economy in such circumstances.) During the last year, SBC, NYNEX, Bell Atlantic, Ameritech, BellSouth and GTE have entered into agreements with such IXCs as AT&T, Sprint and LDDS WorldCom to resell their long-distance services—at prices in the one to two cents per minute range.[28] The addition of switched access charges (by imputation at the originating end and by payment to other LECs at the terminating) of about six cents per conversation minute and any additional costs associated with customer service, marketing, billing and collections[29] would evidently produce total LRICs on the order of ten cents per minute—leaving wide room to under-price the IXCs.

Economies of scope

29. We have already referred to AT&T's claim that its service to residential customers does not break even until their long-distance bills reach $3 a month, because there are fixed

[28] "NYNEX To Resell Sprint Service," Bloomberg LLP, April 24, 1996. "Bells, GTE Lay Out Marketing Strategies, Swap Success Stories at New York Conference," *Telecommunications Reports*, September 26, 1996. McElroy, C., "BellSouth To Buy Time On AT&T's Long-Distance Network," Bloomberg LLP, June 19, 1996.

[29] See the various estimates summarized in note 12, above.

costs of serving each customer regardless of his or her volume of usage. The BOCs already incur many of those customer costs because they already serve most of those customers in-region: this means the incremental customer costs of adding long-distance to their present mix of services are small.

30. Another way of characterizing this positive case for removing the barriers to BOC provision of interLATA services is the fundamental proposition that they—like all other potential entrants—possess strong capabilities and potential comparative advantages in the interLATA marketss and are therefore well-positioned to make important, welfare-enhancing contributions that they are currently prohibited from making. These advantages are an example of the economies of integration or of scope. They arise whenever conduct of two or more activities in a single firm is more economical than if they were conducted by separate firms—generally because of the presence of facilities, personnel or capabilities that can be shared by them. The achievement of these economies is frustrated when markets are Balkanized and firms in one arbitrarily excluded from another—arbitrarily in the sense that the reasons have no grounding in technology or economics—as occurred when the MFJ excluded the RBOCs from the interLATA and the interexchange carriers from the intraLATA business. In the absence of regulatory or statutory restructure, the cost to the BOCs of adding the provision of interLATA toll to a plant and organization already designed to provide only intraLATA services would be lower than the cost of setting up a separate entity to serve that market alone—because, obviously, they already possess a large portion of the capabilities of taking on those additional functions.

31. These at present incompletely utilized talents or facilities represent opportunities for the firm as a potential supplier of those other common products or services. To minimize their total costs and to recover their fixed and common costs—particularly under the constraints of competition—telecommunications firms must constantly seek out and develop services or lines of business that generate economies of scope with their current service mixes.

32. Both the BOCs and IXCs are precluded from taking full advantage of those economies today—the former because they are prohibited from combining interLATA traffic with their current intraLATA offerings, the latter to the extent they are unable to add local exchange service to their long-distance offerings. That of course is why the Telecommunications Act requires the LECs to make those services available to other providers at wholesale and links the removal of the first handicap, symmetrically, to the removal of the other.

33. That a central purpose of the Telecommunications Act is to achieve a symmetrical lifting of restrictions on the exploitation of economies of scope by any and all participants in the market is manifest throughout its text. One particularly apt illustration is the provision that restricts large IXCs from jointly marketing their own interLATA services with local exchange services purchased from a BOC until the latter company is itself authorized to provide interLATA services in region or until 36 months have based from the date of its enactment.[30] This clear intention of the Act to free all competitors, symmetrically, to take advantage of their own particular economies of scope is further reflected in its explicit stipulation that the

[30] *Telecommunications Act of 1996*, Public 104-104, February 8, 1996, Sec. 271(e). The same time period applies to the separate subsidiary requirement on the BOCs under Sec. 272.

requirement on the BOCs to offer their interLATA services through a separate subsidiary be limited to three years from the date of authorization, unless extended by FCC rule or order. Clearly that requirement, which cannot but entail sacrifice of some of those economies in the case of the BOCs, should be removed at the earliest practicable date.[31]

34. BOC entry is almost certain to produce benefits besides driving and holding prices closer to present incremental costs. Competition is a dynamic process. It exerts powerful pressures on suppliers to improve productivity and to be innovative. The incumbent interexchange carriers may contend that competition is already sufficient for these purposes. Such an assertion cannot possibly be valid, especially when the prospect is one of entry by a new type of competitor—different in the mix of services it provides, the distinctive features of its technology and the depth of its customer base. Elimination of the barriers to this new and powerful source of competition will introduce new, additional stimuli to improving productivity and innovation as well as to genuine price competition for the patronage of residential and small business customers—a protection essential now that the FCC's approval of AT&T's petition to be classified as non-dominant has virtually eliminated previous regulatory restraints.

35. In sum, the costs to consumers of a continued prohibition of the BOCs offering interLATA service are very large: this proposition is, we submit, indisputable. What remains to be considered is whether the historical purpose of that restriction—to encourage the transformation of the long-distance business from monopoly to competition by eliminating any incentive on the part of the local telephone companies to use their monopoly power to exclude

---

[30] *Ibid*., Sec. 272 (f) (1).

rivals from a fair opportunity to compete—continues to justify consumers continuing to bear those heavy costs. While we propose seriously to assess the dangers of the BOCs engaging in such exclusionary tactics, it need not bias that discussion if we point out at the outset that our preceding analysis has already definitively answered that question: there is not the slightest doubt that entry by the BOCs into the long-distance business will intensify competition. The converse of that proposition—which we now proceed to expound—is similarly indisputable: there is not the slightest possibility that they could so expand the zero market share with which they begin, debilitate such competitors as AT&T, MCI and Sprint to such a point as to drive them from the market, and thereby restore the vertically integrated monopoly of local and long-distance service that it was the purpose of the consent settlement of 1982 to dissolve.

IV. THE RISKS OF ANTICOMPETITIVE CONDUCT AFTER ENTRY ARE SMALL AND OF SUCCESSFUL SUPPRESSION OF COMPETITION NIL

36. The contentions that the RBOCs should not be freed of the line-of-business restrictions on them because they may be expected, if freed, to engage in anticompetitive conduct have been preponderantly (a) hypothetical—reasoning from their asserted continuing monopoly power and incentives to engage in such conduct and (b) anecdotal—citing asserted instances of such conduct. The combination, however, of (1) the regimes already in existence under which the BOCs had been providing equal and non-discriminatory access to their facilities by the long-distance companies with who they now seek the opportunity to compete, even before passage of the Telecommunications Act of 1996 and (2) the comprehensive requirements of the Act itself and of the FCC's rules implementing its provisions makes the likelihood of

[31] The FCC's implementation of the Act principally limits joint activities to the areas of sales and customer support.

discrimination against competitors extremely remote and of any such discrimination effectively precluding their successful competition nil. This prediction is confirmed by the long history—typically ignored by opponents of the present petitions—of successful competition between the BOCs and competitors dependent on them for essential inputs. We proceed in this section to review these several considerations and that history.

A. Existing Safeguards Against Discrimination: audited service quality standards, monitoring by customer/competitors, penalties and opportunities for retaliation

37. The quality of interexchange access is closely monitored by both competitors and regulators. In order to discriminate successfully in the future, Southwestern Bell would not only have to explicitly violate the new Act; it would have to do so in such a way that the differences in quality would be sufficiently detectable by customers to induce them to shift their patronage to it while going undetected by sophisticated competitors and regulators—an eventuality so unlikely as to border on the impossible.

38. Nor are those competitors dependent solely, for the redress of such discriminations as they do detect, on the protections of government authorities. On the contrary, in keeping with the central purpose of the competitive policies at the State and Federal levels, they already have the protection of being able to turn toward competitors a large percentage of the total business (although still only a minority of subscribers) of any offending BOCs, and in other ways to retaliate against such offenders.

1. The established regime for competition

39. Southwestern Bell's potential competitors are already operating in the interLATA market and dominate it. AT&T, MCI and Sprint are large and powerful competitors, certainly more formidable rivals than MCI and Sprint were to AT&T in 1984. Their nationwide optical fiber networks are in place; their costs are sunk; and their networks can be quickly turned to provide nearly any telecommunications service that appears to be profitable. In this world, competitive strategies involving predatory pricing (e.g., cross-subsidization or a vertical price squeeze) by a new entrant or an incumbent are doomed to fail. For a strategy that sacrifices profits (effectively investing in the destruction of a rival) to succeed, the would-be predator must be able actually to drive the targeted competitor from the market and, by so doing, be in a position to recoup its current losses at some future period. It cannot possibly succeed in this endeavor if the rival is a telecommunications network-based carrier, because there is no way of driving such a network out of the market; the costs associated with it are preponderantly sunk. Whenever the local carrier tired of earning less money in the interstate toll market than it could earn in the carrier access market, it could raise its toll price, but it would find competitors still in place and ready to compete.[32]

[32] These relationships are complicated by the fact that within their own regions the LECs receive revenues both as direct providers of long-distance services and in providing access to other IXCs. This has the consequence that any losses that they might suffer by reducing their retail rates, with anti-competitive intent, would be cushioned by additional sales of access services stemming from the increase in end-market demand stimulated by those price reductions and would therefore not have to be recovered entirely by retail price increases after competitors had been driven out. There are at least two counter-considerations. First, as we have already pointed out, to the extent this dual relationship of the LECs to this market gives them an additional incentive to reduce prices to ultimate customers, that is in itself not necessarily a bad thing, to put it mildly, particularly in a market that is inadequately competitive. Second, these additional access revenues would compensate or more than compensate for the retail price reductions only under special and improbable circumstances: the LEC would have to have a share of the interLATA market sufficiently large to depress the overall market price, if it were to try to put a squeeze on competitors, yet not so large that its consequent loss of revenues from its own retail sales would not be offset by the increase in its revenues from the sale of access to competitors.

40. The second reason is that whereas the rules for entry by competitors into the local exchange market are still in the process of being hammered out, the arrangements for fair access by the long distance carriers to the facilities of the BOCs have been in place for upwards of a decade. Problems of provisioning, repair, billing, segregation of proprietary information and the like have been dealt with on an even-handed basis between the BOCs and interexchange carriers. Those same unbiased interconnection arrangements would continue if the BOCs were permitted to carry interLATA traffic and, as we will point out presently, any deterioration would be all the more visible because of the long-standing nature of the arrangements. Hence there should be little concern that the terms and conditions of interLATA interconnection could tilt the competitive playing field.

2. The anti-discrimination requirements of the Telecommunications Act

41. Irrespective of whether they enter interLATA toll markets, the Telecommunications Act requires RBOCs to provide interconnection and access to unbundled elements on a non-discriminatory basis.[33] The language could not be clearer. Incumbent local exchange carriers have the duty to interconnect

> at any technically feasible point within the carrier's network; that is at least equal in quality provided by the local exchange carrier to itself or any subsidiary, affiliate, or any other party to which the carrier provides interconnection. (Section 251 (c) (2) (B) and (C).)

Moreover, any price reductions encouraged by the complicating consideration we have just described would pose a threat to competition only if the resulting relationship between the access and the retail charges of the BOCs violated the imputation requirements of the Act, and all the other safeguards in place at the state levels as well, designed to prevent predatory pricing.

[33] The unbundled elements include, and indeed can be combined to include, all components of currently-used carrier access services. Coupled with the resale requirements of the Act, these provisions encourage entry without necessarily requiring large amounts of investment.

Further, ILECs have

> [t]he duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and Section 252. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service. (Section 251 (c) (3)).

42. Further satisfying this nondiscrimination standard is the "checklist" contained in Section 271 spelling out the prerequisites for that entry.

43. Notwithstanding this clear Congressional directive for non-discriminatory interconnection, we must confront the counter argument that the BOCs will have every incentive and all sorts of possible devious ways of flouting it.

44. As we have already pointed out, access arrangements have been in place for over twelve years—a period in which the RBOCs had strong incentives to provide high quality service, undiluted by competitive (or anti-competitive) considerations. Those incentives have been intensified by the emergence of competitors for access traffic: every major metropolitan area in the country—embracing a very large share of the BOCs' total business—is now served by at least one CAP. And, it is important to bear in mind, it is in the provision of <u>access</u>, not of other local exchange services, that opponents of the RBOCs claim those companies will discriminate against rival IXCs if permitted to compete with them.

45. Explicit oversight by both regulators and purchasers of access provide strong additional guarantees of good service. Quality standards are often built into tariffs or other

administrative rules, and they are regularly monitored and audited by IXCs and regulatory agencies alike. The FCC routinely monitors them through quarterly and semi-annual reports of measures such as installation and repair intervals, post-dial delay, transmission quality and service quality complaints. Finally, RBOCs have worked out monitoring and auditing programs directly with their IXC customers, programs that may include financial penalties for failure to meet quality standards.

46. Our conclusions about the sufficiency of these safeguards have just had the explicit endorsement of the FCC. The Commission states in its recent order on non-accounting safeguards,

> We believe...that sufficient mechanisms already exist within the 1996 Act both to deter anticompetitive behavior and to facilitate the detection of potential violations of section 272 requirements.
>
> We also find that, beyond the reporting requirements mandated under the 1996 Act, there are other avenues by which a telecommunications carrier may obtain information relevant to detecting anticompetitive BOC conduct. For example, competitive telecommunications carriers, on their own initiative, could seek to incorporate certain performance and quality standards into their negotiated or arbitrated interconnection agreements to ensure that BOCs satisfy their obligation to provide service in a nondiscriminatory manner.

And, it concludes,

> We believe that the reporting requirements required by the 1996 Act, those required under state law, and those that may be incorporated into interconnection agreements negotiated in good faith between BOCs and competing carriers will collectively minimize the potential for anticompetitive conduct by the BOC in its interexchange operations.[34]

[34] First Report and Order and Further Notice of Proposed Rulemaking, In The Matter Of Implementation Of The Non-Accounting Safeguards Of Sections 271 and 272 Of The Communications Act Of 1934, as amended, FCC, CC Docket No. 96-149, Adopted: December 23, 1996, Released: December 24, 1996, pars. 321, 326 and 327.

3. Accounting safeguards

47. If there is one task at which regulators have proved themselves adept both before and since divestiture, it is in allocating costs in such a way as to protect purchasers of regulated—and, in particular, basic exchange—services and, by so doing, protecting competitors from cross-subsidization. Whether in so allocating costs as to set floors under the prices of competitive services markedly above incremental costs or in setting ceilings on basic service rates below incremental costs—and even farther below economically efficient levels—regulators have erred in the direction of over-protecting competitors from efficient competition and underpricing regulated services.[35]

48. In addition, the Commission has now officially found that its various accounting safeguards, including its existing rules governing transactions between the LECs and affiliates, are fully sufficient to guard against subsidization of competitive activities at the expense of subscribers to regulated telecommunications services.[36]

---

[35] Crandall and Waverman, *op.cit.*; A. E. Kahn, "The Uneasy Marriage of Regulation and Competition," *Telematics*, September 1984, pp. 1-2, 8-17 and "The Road to More Intelligent Telephone Pricing," *Yale Journal on Regulation*, Vol. 1, No. 2, 1984, pp. 139-157; and D.L. Kaserman and J.W. Mayo, "Cross-Subsidies in Telecommunications: Roadblocks on the Road to More Intelligent Telephone Pricing" *Yale Journal on Regulation,* Vol. 11, No. 1, Winter 1994, pp. 119-147.

[36] Report and Order, In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996, FCC 96-490, CC Docket No. 96-150, adopted: December 23, 1996, Released: December 24, 1996

> our cost allocation and affiliate transaction rules, in combination with audits, tariff review, and the complaint process, have proven successful at protecting regulated ratepayers from bearing the risks and costs of incumbent local exchange carriers' competitive ventures, (par. 25)

and:

> We have previously concluded that these [affiliate transaction] rules provide effective safeguards against cross-subsidization. (par. 108)

See also pars. 1 and 275.

B. The Unbundling, Resale and Interconnection Provisions of the 1996 Act and the Section 271 Checklist

49. Manifestly, the provisions of the Act and the FCC's Interconnection Order have had the intention, and will have the effect, of strengthening the competitive safeguards previously instituted:

- The FCC's Interconnection Order would substantially expand and accentuate the degree of mandated non-discriminatory access to essential inputs. Not only are more unbundled elements to be provided at a greater number of points of interconnection, the prices charged for these elements must be approved under an open process and comply with explicit rules designed to afford rivals a fair opportunity to compete. If anything, these new terms and conditions are too restrictive, to the detriment of efficient competitive initiatives and responses on the part of the incumbents.[37]

- The Telecommunications Act imposes restrictions and handicaps, for a limited number of years, on the offer by incumbent LECs of services they were previously barred from offering at all—such as in-region interLATA toll and manufacturing. These restrictions, in the form of required structural separations and limitations on the marketing of local exchange and other services, would limit their exploitation of economies of scope and thereby handicap them in competing with rivals, to which these restrictions would not apply.

[37] A detailed critique of the Interconnection Order is unnecessary to this declaration. Our major concerns about it are that the prices and terms of access may be unduly favorable to entrants that choose to compete through resale of incumbents' services and use of unbundled elements. The adverse consequences of such an imbalance include: (1) diluting the incentives for facilities-based entry into local exchange services and (2) eroding the incumbents' incentives to upgrade their networks and offer innovative services.

50. The incumbents' ability to offer in-region interLATA services is dependent on their satisfying a "checklist" of requirements, which include nondiscriminatory access to essential inputs and the demonstrated presence of competition for local exchange services.[38] These requirements hasten the erosion of the "local bottleneck"—the basis for the historical concern about anticompetitive behavior—and make lifting of the ban on interLATA services contingent on the FCC's being satisfied that the possibility of such behavior has been sufficiently minimized by the presence of local competition or its possibility.[39]

C. Successful Competition between Vertically Integrated RBOCs and Firms Requiring Access to Their Facilities in Other Markets

51. There has accumulated, over the last decade or more, a great deal of actual experience with competition between the RBOCs—and LECs that are not BOCs—on the one side, and rivals dependent on access to their facilities. An ounce of actual experience is surely weightier than a pound of speculation about possible misdeeds or, indeed, of anecdotal claims about exclusionary practices. Assertions about the theoretical inadequacies of regulatory safeguards against predation, cross-subsidy and discriminatory treatment of competitors simply ignore this historical evidence. In practice, competition by non-vertically integrated firms with RBOC "bottleneck monopolies" has already succeeded in other telecommunications markets that are at least as susceptible to anti-competitive tactics as the interLATA market—geographic corridors in which the BOCs have been permitted to offer interLATA service, cellular, paging,

---

[38] Alternatively, if no qualifying entrant pursues interconnection within the state, the BOC's demonstration that the necessary conditions for entry have been established will suffice (so-called "Track B" for interLATA entry).

[39] In fact, the "local bottleneck" is already eroding, independently of the Telecommunications Act, as indicated by the fact that revenues for competitive local exchange carriers grew by 80 percent in 1996. ("CLEC Revenues Grow 80% in 1996, Report Finds," *Telecommunications Reports*, February 5, 1997.)

voice messaging services (VMS), customer premises equipment (CPE), intraLATA long distance and the offer of long-distance service by LECs other than BOCs.

1. InterLATA corridor traffic

52. RBOCs have routinely provided interLATA services since divestiture under exceptions to the AT&T consent decree, the notable example of which is Bell Atlantic's interLATA service between New York and New Jersey. In that narrow market, the RBOC offers rates about 20 to 30 percent below AT&T's;[40] yet it has only a small share of this traffic, despite purported overwhelming advantages stemming from its control over local service.[41] Over ten years have passed without adverse consequences for competition.[42]

2. InterLATA service offerings by non-BOC LECs

53. Large LECs as GTE, SNET, United Telephone, and Rochester Telephone (now Frontier) have similarly offered interLATA services without apparent anti-competitive effect. The SNET experience in Connecticut is quite informative.[43] SNET began offering out-of-state service in April 1994 at rates 15 and 25 percent below AT&T's undiscounted rates for peak and off-peak calling respectively. By the end of 1996, SNET had captured about 30 percent of the market, thereby providing large benefits to consumers in the form of lower prices and new

---

[40] "Bell Atlantic Seeks Nondominant Status in `Corridor'," *Telecommunications Reports*, July 17, 1995.

[41] The same is true of NYNEX. The fact that these two RBOCS serve corridor traffic only through 10XXX access may explain their relatively small shares in their respective corridor areas.

[42] That the FCC is of the opinion that anti-competitive behavior has not been a significant problem in these markets is suggested by the fact that when, in September 1990, it placed these interLATA services provided by LECs under price caps, it elected not to subject them to price floors, as it had in other such situations.

[43] Joint Affidavit of Robert Crandall and Leonard Waverman on Behalf of Ameritech Michigan, In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region InterLATA Services in Michigan, FCC CC Docket No. 97-1, Vol. 3.1, January 2, 1997, pars. 53-54.

service offerings. For all the reasons we have already summarized, Southwestern Bell's entry into interLATA service may confidently be expected similarly to benefit consumers, without denying its rivals a fair opportunity to meet that competition.

3. Cellular

54. LECs have participated in cellular telephony since 1983. The service is organized as a (largely) unregulated duopoly in the United States, with entry limited by the availability of only two 25 MHz channels in each geographic market. At its inception, one channel was allocated to wireline carriers (generally a BOC or GTE) and the other to non-wireline providers. The simple fact is that the wireline licensees (the LECs) have not come to dominate the market, as would have happened if they had been able to subsidize these services from their local telephone services or otherwise to discriminate against their competitors. Despite a late start, non-wireline suppliers have nearly equal market shares.[44] Indeed, the largest cellular company in the U.S. is AT&T/McCaw, a non-wireline supplier, and seven of the top ten companies ranked by the ratios of subscribers to population covered are not BOCs.[45]

55. Perhaps the best evidence, though, that participation by SBC and other incumbent LECs in the cellular business does not foreclose competition comes from the wireline carriers themselves. Though they are presumably most knowledgeable about the real risks of anti-competitive conduct directed at them by the incumbent wireline carriers, the number of territories in which telephone company cellular affiliates compete with one another has grown

---

[44] Paul Kagan Associates, "Cellular Ownership," *Wireless Market Stats*, August 31, 1995, No. 72; and Donaldson, Lufkin & Jenrette, *The Wireless Communications Industry*, Table 2A: Cellular Industry - Quarterly Subscribers, Summer 1996, p. 10.

rapidly from about 5 in 1986 to more than 30 in 1995.[46] And a company as knowledgeable and sophisticated as AT&T has sunk billions into this market through its purchase of McCaw and PCS licenses—powerful objective evidence that its frequently expressed concern about LECs discriminating against it, in favor of their cellular affiliates in their home territories, has not deterred it from entering into competition with them.

4. Paging

56. Paging markets tell a similar story. While LECs have been important participants, they have always been far from dominant. The largest suppliers, Paging Network and MobileMedia, are not affiliated with an LEC, and another large firm, SkyTel became the first to introduce two-way paging (in September 1995). All told, radio common carriers provide the largest share of these services; LEC affiliates account for only about 20 percent of the total. The paging market is characterized by successful entry (SkyTel's satellite service in 1987) and exit (MCI's sale of its paging and cellular interests to McCaw in 1986, NYNEX's sale to Page America in 1990 and MobileMedia's acquisition of BellSouth's paging subsidiary in January 96[47]). Again, however, concerns that the LECs might cross-subsidize their offerings of these competitive services have proved unfounded; many years of competition have not eventuated in their dominating the business.

---

[45] Paul Kagan Associates, "Cellular Industry Eclipses Projections (Again)," *Wireless Telecom Investor*, March 14, 1994, No. 73.

[46] The 1995 number reflects direct competition among the former BOCs except for Pacific Telesis, which spun off its cellular company (now known as AirTouch Cellular).

[47] "M&A: MobilMedia Corp.," *Telecommunications Reports*, January 8, 1996.

5. Voice Messaging Service (VMS)

57. Many LECs have long been allowed to provide information services, and SBC and the other BOCs also have been allowed to enter those markets in recent years—all without evidence that competition has been undermined.[48] Since the BOCs and GTE began offering VMS, consumers have benefited in at least two ways. First, the monthly charge has dropped from $30 in 1990 to $5-$15 in 1995.[49] Second, the LECs began offering VMS to residential and small business customers, a thitherto untapped market segment. In five years, the BOCs' participation in this market increased from zero to over six million subscriptions, yet competitors have thrived and the BOCs and GTE together account for just over 15 percent of the total revenues nationally.[50]

6. Customer premises equipment

58. Though barred from manufacturing, SBC and the other BOCs have been permitted to distribute CPE. Like the case of interLATA toll, competitors to the BOC must interconnect with the incumbent's network—typically in the form of connecting CPE to a BOC-provided access line. There is no evidence—nor have there, to our knowledge, been even assertions—that they have attempted, by exercising their market power, to exclude competitors;[51] let alone

---

[48] In addition, the FCC has ruled that the Open Network Architecture (ONA) safeguards are sufficient to deter conduct that has been alleged to be anticompetitive in the past. (Bell Operating Companies Joint Petition for Waiver of Computer II Rules, Order, 10 FCC Rcd. 13764 , 1995, par. 32.

[49] Hausman, J.A. and T.J. Tardiff, "Benefits and Costs of Vertical Integration of Basic and Enhanced Telecommunications Services," April 6, 1995.

[50] *Ibid.*, pp. 5, 10.

[51] NERA staff reviewed complaints filed against the BOCs with the FCC between 1985 and 1991 and found no complaints about the offering of interconnection of CPE.

succeeded. Indeed, their collective market share of CPE distribution is small, on the order of 10 percent.[52]

7. IntraLATA toll

59. The final and most directly relevant evidence is to be found in intraLATA long distance. Nearly all states permit intraLATA toll competition; and in none of them have SBC and the other LECs been required to divest themselves of their toll businesses or even to create separate subsidiaries. When the IXCs entered these markets, they (i) started with small initial market shares, (ii) had few facilities within the LATA, so that they were heavily dependent on the LECs for access to subscribers, (iii) did not have complete dialing parity, and (iv) had to compete against inexpensive local calling within the LATA and overcome initial ignorance on the part of subscribers that they now had a choice of intraLATA long distance providers. Even under these circumstances, LECs are losing significant amounts of market share, particularly for large business customers that combine interLATA and intraLATA traffic on the same dedicated facilities. The success of competition for long distance intraLATA business is strong evidence that the hypothetical dangers of discriminatory treatment of BOC affiliates and their competitors are in fact adequately precluded by existing regulatory safeguards.

V. THE IMPORTANCE OF SYMMETRY IN EXTENDING THE FREEDOM TO COMPETE

60. As we have already observed, the provision in the Telecommunications Act prohibiting joint marketing of local exchange and interexchange services by major IXCs (carriers serving more than five percent of the nation's lines) that resell the incumbents' local exchange

[52] NATA, *1991 Telecommunications Market Review and Forecast*, p. 60.

services until such time as the incumbent LECs qualify for interLATA entry—at which time, both incumbents and competitors would be permitted to market services jointly—is clearly intended to preserve competitive parity between those two. It also reflects the extent to which the markets for the several telecommunications services are converging and the necessity, if all participants are to compete on equal terms, for all to have equal freedom to bundle their various services and offer customers one-stop shopping.

A. Blurring of Boundaries between Markets; the Importance of One-Stop Shopping

61. The industry has reacted to the recent dramatic technological and regulatory changes with a kaleidoscopic variety of new ventures, typically involving entry into other markets, preexisting and new—sometimes by companies operating alone, at other times through partnerships or acquisitions—as each attempts to take advantage of these exploding opportunities (or perceived opportunities). All give rise to the prospect of turbulent competition among them. All three of the major IXCs have made commitments to the local market. AT&T's purchase of McCaw Cellular allowed it access to local networks covering about half of the United States and it has strengthened its position in these areas by winning licenses in 21 major markets in the recent PCS auctions, with bids totaling approximately $1.7 billion. AT&T has also explored alliances with such small non-Bell local providers as Metropolitan Fiber Systems,[53] as well as cable companies, such as Time Warner.[54] In terms of local wire services,

[53] "AT&T Vows Battle to Offer Local Service," *The Wall Street Journal*, October 27, 1995, P. A4.

[54] Keller, John J. and Eben Shapiro, "Time Warner's Cable-TV Unit, AT&T in Talks," *The Wall Street Journal*, May 16, 1995, p. A3. Additionally, AT&T has filed plans with the FCC to bypass local connections, using an advanced satellite communications system. B. Ziegler, J. Cole, Q. Hardy, "Satellite Plan Would Let AT&T Bypass Local Networks," *The Wall Street Journal*, October 5, 1995, p. A6.

AT&T already has installed "more than 100 local switches and special computers for routing traffic."[55]

62. MCI and Sprint also have made major commitments to entering the local market, bypassing LEC facilities. MCI entered into partnership with British Telecom to advance their respective positions. There seem to be at least three reasons for the deal—the hope of i) reducing capital costs;[56] ii) improving their combined ability to engage in global marketing;[57] and iii) achieving economies of scale and scope.[58] Sprint has major cellular holdings and has joined with cable companies in a number of areas to offer basic telephone service, as well, of course, as the more remunerative local exchange services that go with it. Furthermore, in the most recent PCS auction, Sprint, once again in alliance with major CATV companies, was awarded large blocks of radio spectrum, which they apparently intend to use to offer basic local exchange as well as innovative services.[59] Sprint has also recently entered into partnership with Deutsche Telekom and France Telecom, which will allow the European firms to obtain a large jump-start

---

On the other hand, as but one prominent illustration of the rapidity with which these plans change, TCI—the country's largest cable operator—has just signaled its intention to abandon its previously announced ambitious plans to offer telephone services, "Malone Says TCI Push into Phones, Internet, Isn't Working for Now," *The Wall Street Journal*, January 2, 1997, p. A1.

[55] "AT&T Vows Battle to Offer Local Service," *The Wall Street Journal*, October 27, 1995, Page A4. In fact, Robert Allen, AT&T's chairman, stated on February 8, the day the Telecommunications Act became law, that it had the ability to directly connect its large business customers to offer local exchange service. To put the 100 switches into perspective, note that the RBOCs currently have about 6,000 switches (not including remotes). Because (1) the switches of new local exchange entrants are likely to be placed in areas with higher volumes and (2) such entrants will be able to obtain unbundled switching from the ILECs, this simple comparison of the number of switches understates their importance.

[56] "BT Agrees to Invest $4.3 Billion for 20% of MCI; New Joint Venture," *Telecommunications Reports*, June 7, 1993.

[57] *Ibid.*

[58] "BT/MCI 'NewCo' Venture to Offer Brand Name Services on platform Including Syncordia, Cyclone Network Assets," *Telecommunications Reports*, June 7, 1993.

[59] "RCI and Sprint would be strategic fit," *The Financial Post*, Daily Edition, Tuesday, October 3, 1995.

in the United States market and allow Sprint to do the same in Europe. The apparent plan is for each to own a one-third share in a joint venture, Phoenix, aimed at serving the multibillion-dollar market for global communications.[60]

63. Other firms similarly compete for position in these existing and emerging markets. For example, US West has come to an agreement with Continental Cablevision, which has a separate agreement with Time Warner. Electric utilities may provide a significant source of competition: many of them have excess fiber capacity[61] and large capital reserves, which make the telephone market appealing to them.

64. These investments, partnerships and market interpenetrations are powerfully impelled by potential economies on both the demand and the supply sides. The former spring from the attractiveness to consumers of one-stop shopping—purchasing expanding bundles of services, at attractive prices, from single, familiar suppliers. On the supply side, there are ubiquitous promised economies of scale and scope. The greater the capacity of switches and transport facilities, the lower are unit costs: this means the incremental costs of adding capacity are lower than average costs. Similarly, the use of common facilities permits the offer of additional services at incremental costs much lower than if they had to be provided on a stand-alone basis. Entry into new lines of business at rates above those low incremental costs provides the opportunity to earn contribution toward common and fixed costs and higher profits.

---

[60] "With Variations, Sprint Announces European Pact, "*The New York Times*, Late Edition, Friday, June 23, 1995, p. D2.

[61] For example, SCANA Corp., the parent company of South Carolina Gas and Electric, currently controls 2,500 route miles of cable fiber through its subsidiary MPX Systems, Inc., and is planning to double that. "Growing Utility Fiber Market Tempered by Considerable Hesitancy," *Fiber Optics News*, Vol. 15, No. 19, May 15, 1995.

65. These economies have a dynamic as well as a static aspect. Complementary goods become more plentiful and of higher quality as the number of users of any one of them—such as basic telephone service—increases. Since consumers seem to prefer the supplier of communications services that gives them access to the largest number of complementary services—video on demand, internet access, information services, database access—and tend to value the convenience of purchasing these services bundled from a single supplier, there is a very strong incentive for the various participants in this industry, once freed from legal and regulatory barriers, to compete in developing these new bundles of services.

66. In sum:

> From all this dealmaking will emerge a new crop of supercarriers—companies that either on their own or through alliances will offer a full menu of electronic communications, a telebazaar with everything from video phones to Internet services to a single phone number that will follow you wherever you go.
>
> ... The companies most likely to come out on top are those with the best marketing skills, the strongest brands, the deepest pockets, and a familiarity with competition. In other words, AT&T, MCI and Sprint—the long-distance giants— are best positioned for the future.[62]
>
> The impetus for the current move to join forces is burgeoning competition and demands from customers for better, simplified service. To respond, carriers worldwide are seeking the right combination of assets for offering a raft of local, long-distance and wireless services. To package these services, some carriers that lack the right mix of products must find partners or acquisitions lest they be picked clean by the aggressive entrants such as AT&T Corp., MCI Communications Corp. and others.[63]

---

[62] Arnst, Catherine C. and Michael Mandel, "The Coming Telescramble: Deregulation Is Launching A $1 Trillion Digital Free-For-All," *Business Week*, April 8, 1996, pp. 65-66; emphasis added.

[63] Keller, John J. and Gautam Naik, "Telecommunications: SBC-PacTel Merger Is Likely to Ring In An Era of Alliances Among Baby Bells," *The Wall Street Journal*, April 2, 1996, p. B1.

B. The Adverse Consequences of Asymmetrical Restrictions on the Ability to Compete Reciprocally

67. As a general proposition, asymmetrical regulation attenuates both the incentives and the ability of some providers to avail themselves of these scope and scale economies and to pass the benefits on to their customers, under the pressures of competition. As a result, large benefits are lost and significant costs incurred.[64] Specifically,

- Stifling the incentives of RBOCs to offer new services costs society billions of dollars annually in lost consumer benefits.

- "One-stop shopping" can be worth a substantial part of the value of a product or service to consumers. Thus, competitors that can offer "one-stop shopping" have a considerable competitive advantage over those than cannot.[65]

- The sacrifices of scope economies entails artificially inflated production costs.

68. The upgrading and modernization of the switched public network and the fullest exploitation of its capability of offering a variety of sophisticated and innovative services—which are the central goals of the Telecommunications Reform Act—depend not just on freeing the telephone companies and all others from restrictions and handicaps on their ability to do so;

---

[64] Hausman and Tardiff, op. cit.

[65] See for example, "Study Says Consumers Would Buy Bundled Services," *Telecommunications Reports*, August 12, 1996. That article reports that almost 80 percent of U.S. households would buy bundled services from a single provider. Other studies have quantified the value of "one-stop shopping" to consumers. For example, see Testimony of Arthur T. Smith on behalf of Southern Bell, Docket No. 930330-TP (Fla. P.S.C. July 1, 1994). This preference for one-stop shopping cuts across cultures: a study of Japanese consumers has estimated the value of the ability to obtain calling services from a single provider at about 14 percent of the average price. Timothy J. Tardiff, "The Effects of Presubscription and Other Attributes on Long-Distance Carrier Choice," *Information Economics and Policy*, Vol. 7, 1995, pp. 353-366.

it also requires offering all parties the full, undiluted incentives of a free market system to undertake the requisite, typically risky investments.

69. Those incentives are of two kinds. The first is the stimulus of competition itself. The strongest case for substituting the discipline of competition for that of regulation is the superior ability of the former to exert pressures on all producers to be efficient and innovative, if they are to survive, let alone prosper. The second is the self-interest of the telephone companies, freed from continuing restrictions on the services they are permitted to offer.

70. Particularly during the next several years, when we will necessarily continue to depend very heavily on the ILECs for accelerating the deployment of an advanced telecommunications infrastructure, it is essential that we not weaken the second of these incentives in a misguided effort to strengthen the first. Attempts to micromanage the process of deregulation, we have found in other industries, are more likely to produce distortions than actually to encourage efficient competition.[66] Ultimately, both incentive systems require the shrinking of regulation and of all such regulatory restrictions to the absolute minimum and entrusting protection of the public to deregulated competition—subject, as always, to the constraints of the antitrust laws. But in the interim, delay in allowing SBC and the other RBOCs the opportunity to offer both local and interexchange services is not only unnecessary to preserve equal competitive opportunities for equally efficient rivals. It would be blatantly anti-competitive, because it would unnecessarily deny the SBC the ability to offer the same combinations of services, exploiting the same economies of scope, as both Congress and the

[66] Kahn, Alfred E., "Applications of Economics to an Imperfect World," the Richard T. Ely lecture, *The American Economic Review, Papers and Proceedings*, Vol. 69, No. 2, May 1979, pp. 1-13.

FCC have taken extraordinary pains to ensure will be available to their competitors. And by weakening both the ability and the incentives of the BOCs to invest in modern infrastructure and to innovate, it will tend to frustrate achievement of a central goal of the Act.

VI. SUMMARY AND CONCLUSIONS

71. The desire of the BOCs to have the restriction on their ability to offer interLATA service lifted is a desire to compete: that is clearly the place to begin in assessing their petition. There can be no questioning the proposition, then, that the presumption in any system that is supposed to be governed by competition must be in favor of permitting such extensions of the operations of existing firms.

72. What the BOCs are asking for permission to do is, precisely, to extend their operations from the supply of the "raw material"—local access—into the supply of one of the major end-services making use of that input. Vertical integration of this kind is most likely to recommend itself to companies—and, by the same token, to be socially creative and competitive in its effects—when it represents a fuller use of existing capabilities—equipment, knowledge, managerial capabilities, marketing facilities—of the integrating firm—that is to say, when it represents a fuller exploitation of potential economies of scope.

73. That is obviously the case here. Subject to the Act and the FCC's Interconnection Order, the same Southwestern Bell facilities—switches, transport facilities, marketing operations—as provide local exchange and intraLATA toll services can also supply long-distance services, which, packaged with the others, are much more attractive to consumers than each or only some of them supplied separately. For exactly the same reasons, long-distance

companies, cable and cellular operators are eager to use their existing capabilities and facilities to add local telephone services to their offerings. Integration in both directions would, manifestly, be competitive.

74. We have taken pains to assess the possibility that special circumstances sufficiently extreme in the opinion of the Department of Justice in the early 1980s to justify imposing the line-of-business limitations on the BOCs continue to justify a continuation of that prohibition of the intense competition that they are in a peculiarly excellent position to supply.

75. The ultimate economic question is whether SBC and the other BOCs can possibly, by the exercise of such diminishing but residual monopoly power at the local level as they possess, succeed in suppressing competition as an effective force in the market they wish to enter—suppress competition, that is to say, as contrasted with discommoding competitors.

76. And this leads to our final and in a real sense definitive point. We find the ultimate essential component of the successful strategy of cross-subsidization, predation or exclusionary tactics hypothesized by opponents of BOC entry into the interLATA market—namely, the permanent removal or disabling of competitors sufficient to enable the predator to recover the costs of those cross-subsidizations or other schemes by raising prices—flatly inconceivable. The incumbent long-distance providers are in command of 100 percent of the market. They have installed capacity that is not going to go away. The marginal cost of operating it is low, leaving its owners with latitude for matching price reductions more than sufficient to dissuade any would-be predator. It is the present long-distance companies that are the dominant firms in that market. In these circumstances, we find it simply inconceivable that they would or could either

be driven out of business or be so debilitated by discriminatory tactics practiced by the BOCs as to weaken the protection of their continued competitive presence. In these circumstances, entry by SBC and the other RBOCs could only be beneficial to consumers.