The American
Antitrust Institute

July 24, 2006

Hon. Mike DeWine
Chairman, Antitrust, Competition Policy
and Consumer Rights Subcommittee
United States Senate
Committee on the Judiciary
Washington, D.C. 20510-6275

Re: Answers to follow-up questions for the hearing "The AT&T and BellSouth Merger: What Does It Mean for Consumers?" before the Subcommittee on Antitrust, Competition Policy and Consumer Rights

Questions of Senator Mike DeWine

Question 1.

For some businesses, AT&T and BellSouth are among the few—if not the only two—providers which offer the type of complex telecom services they need. Although, as the testimony for this hearing has shown, there appears to be some dispute about how many businesses will find themselves in this position. Due to this merger, many of these businesses will be losing a choice, and some may even be left with only one choice, which raises obvious competitive concerns. On the other hand, however, a combined company may be in a better position to invest in new services for business and corporate customers. How do the merged company's claims of an enhanced ability to invest in new services for business customers weigh against the potential loss of competition due to this merger, and how does this merger affect the marketplace?

Answer

The proposed AT&T-BellSouth merger touches a large and complex system of markets for telecommunications services. In addition, profound institutional, regulatory and technological changes are now taking place which also impact the competitive assessment of the proposed merger. On balance, it is more likely that competition between AT&T and BellSouth in each firm's respective service region would result in a greater level of aggregate investment and yield greater social benefits than a merger that eliminates any possibility of competition between the two firms. This is because new technologies undermine the need for common ownership of network infrastructure to achieve interoperability and provide next generation services. Claims that the merger is necessary to stimulate additional investment to achieve a greater level of

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service for customers are without merit, for the reasons set forth with more particularity in the answer to Question 3, below.

Question 2.

When the Justice Department looked at the SBC/AT&T merger, and the Verizon/MCI merger, they focused on loss of competition for high-capacity business customers, and to address that problem, they utilized an unusual remedy - - something known as an "indefeasible rights of use." Basically, this is like a long term lease that provides a certain amount of service to these businesses. How has this remedy been working? Do you think it has been effective at maintaining competition in these markets?

Answer

The contracts for the IRUs to be divested in connection with the SBC/AT&T and Verizon/MCI mergers remain executory, pending approval of the mergers by the district court, which is currently in the process of its Tunney Act review. Accordingly, it is as yet impossible to determine the efficacy of this type of remedy.

However, there is no reason to be optimistic that IRUs will fulfill the intended function of a divesture in this context. According to the *Antitrust Division Policy Guide to Merger Remedies*,[1] "divestiture assets must be substantial enough to enable the purchaser to maintain the premerger level of competition,…."[2] The most significant feature of the proposed IRU remedy is the divestiture of dark circuits without an associated revenue flow. The divestiture of un-used circuits on a building-by-building basis is unlikely to maintain premerger levels of competition for several reasons.

First, the existence of an independent operator of circuits in a particular location is unlikely to replace lost competition because the potential customer base for such circuits is already fully serviced. Well-known pricing and discounting strategies by incumbent LECs bind enterprise customers to minimum spend levels or capacity usage, creating a strong disincentive for such customers to switch to rival operators that may own capacity that serves a particular location.

Second, while a particular building may house enterprise customers with a single point-of-presence ("POP"), enterprise customers are more likely to require private line services to multiple POPs. Such customers do not bid on or purchase private line services on a building-by-building basis but instead negotiate for services for all of its POPs on a regional, national, or global basis.

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[1] U.S. Department of Justice, Antitrust Division, October 2004, available at: <http://www.usdoj.gov/atr/public/guidelines/205108.htm>.

[2] *Id.*, at 9-10.

Finally, there is a legitimate question with respect to the criteria applied by the Department of Justice in determining which buildings should be the subject of the IRU remedies. Putting aside the inadequacy of a building-by-building market definition where buyers do not buy and sellers do not sell on such a basis, the remedies proposed in both mergers are limited only to those buildings in which the number of providers is reduced through merger from two to one and where the probability of entry is determined to be low. Thus, the proposed remedies do not regard a reduction in competitors from three to two to involve a substantial lessening of competition. Moreover, the same conditions that indicate a low probability of competitive entry (*e.g.*, large enterprise tenants or isolated locations) are likely to render the IRU remedy ineffective, as well.

A divestiture of circuits currently in use together with the associated revenue flow (*i.e.*, customers) would be much more effective in replacing lost competition. No explanation for proposing IRUs rather than a more traditional remedy is given by the Department, however, other than the fear of the "disruption" that might follow from a more complete divestiture. Disruption of this type, however, is at best a pretext. Network operators routinely engage in "circuit grooming" which moves customers' circuits transparently and without service interruption.

Question 3.

In the past, critics have argued that the old Bell companies avoid competition by staying out of each other's territories. For the most part it is true that we have not seen very much "Bell against Bell" competition, which has been a source of frustration to many consumers and policy-makers as well. But we heard from all of the witnesses at this hearing that this merger will increase investment to integrate the various types of networks, and that we will soon see products being delivered to consumers over the internet, which should change the market dynamic and also the economics of providing those services. Do you think that a combined AT&T/BellSouth would be more likely to enter into Verizon's and Qwest's territories than it has so far?

Answer

The proposed AT&T/BellSouth merger will *decrease* rather than increase "investment to integrate various types of networks," a proposition the merging parties readily admit. For example, the parties explain that each of the three pre-merger firms (AT&T, BellSouth, and Cingular) "must design and build its own IMS [IP Multimedia Sub-system] network."[3] They explain that "capital is being spent on three systems instead of one."[4] In other words, the firms

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[3] Description of Transaction, Public Interest Showing and Related Demonstrations, *Applications for Transfer of Control of Domestic Section 214 Authorizations, Applications for Transfers of Control of International Section 214 Applications, Applications for Transfer of Control of Station Licenses and Operating Authorizations* (filed March 31, 2006) WC Docket No. 06-74, at 13.

[4] *Id.*

without the merger must engage in a level of capital investment that will not be necessary after the proposed merger takes place.

This is a strange justification for the transaction, indeed. An "IMS network" is an IP-based architecture with a logical layer that allows for the convergence and interoperability of wireless and wireline and IP and legacy network infrastructure. It permits the end-user to initiate a session that signals the user's presence on a particular network to all other networks—no matter by whom operated—and to switch freely between them. The entire purpose of the development of the IMS architecture is to promote network interoperability and convergence and to allow smooth and invisible transitions between modalities and proprietary operations. Multiple IMS networks are designed to achieve a level of technological agnosticism that renders the common ownership of dissimilar network infrastructure entirely unnecessary for interoperability. To aver that the proposed merger will achieve efficiencies by requiring only one rather than three separate IMS networks to be built flatly ignores one of the principle advantages and purposes of the IMS architecture in the first place.

Moreover, competition necessarily implies a healthy degree of duplication, the elimination of which acts to the detriment rather than the benefit of the consumer. In the present context there is no reason to believe that IMS implementations adopted by three pre-merger entities will not be able to freely interoperate while at the same time there is no reason to believe that these implementations will be identical. Innovation—both the product and process varieties—results from rival implementations, a clear benefit that will be lost as a result of the proposed merger.

Similarly, the parties claim that the combined company will be a "more attractive partner for content providers."[5] There is little or no support for this statement. The loss of two additional bidders for content will tend to homogenize program offerings as a whole and should be expected to result in less investment in content variety and less locally or regionally responsive programming rather than more.

The failure of the incumbent local exchange carriers (LECs) to compete *inter se* is well known and is the subject of a private antitrust class-action pending in the Southern District of New York.[6] The allocation of territories among competitors is, of course, unlawful *per se* under the antitrust laws. In the case of the incumbent LECs, moreover, such coordination and forbearance from competition would be contrary to the clear policy behind the Telecommunications Act of 1996.

The Verizon/MCI and SBC/AT&T mergers followed closely by the proposed absorption of BellSouth by new-AT&T will create three geographically separate, vertically integrated incumbent local exchange carriers (LECs) (Verizon, Qwest, and the "new" AT&T), an industrial

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[5] *Id.* at 25.
[6] See Twombly v. Bell Atlantic Corp., 425 F.3d 99 (2nd Cir., 2005), *cert. granted* Bell Atlantic Corp. v. Twombly, 126 S.Ct. 2965, 74 U.S.L.W. 3713 (June 26, 2006).

structure that will eliminate any remnant of an incentive for these firms to engage in out-of-region competition by substantially increasing the ease and therefore the likelihood of collusion and continued market allocation, tacit or otherwise. The proposed AT&T/BellSouth merger will render inter-Bell competition less likely than would be the case were BellSouth to continue as an independent network operator.

Question 4.

You expressed concern that this merger takes the nation down a path to a duopoly in the telecom industry, and argue that it is a "giant step." Do you think that it will increase the likelihood of future telecom deals, and if so, why? What merger can we expect to see next?

Answer

The principal concern is the emergence of local cable-telco duopolies as the best-case scenario for mass-market internet access in most communities. This outcome is likely even in the absence of any further consolidation in the industry.

The AT&T/BellSouth transaction represents a "giant step" because it removes a significant potential competitive source of mass market internet access and it all but eliminates any hope of inter-Bell competition for the reasons given in the answer to the preceding question.

In addition, the BellSouth/AT&T transaction represents more than a substantial combination of service territories but also a significant cross-platform consolidation of wireless and wireline technologies. In the absence of the proposed merger, an independent BellSouth and an independently managed Cingular would have significantly greater incentives to invest in and market "stand-alone" wireless broadband access as a competitive alternative to digital subscriber line (DSL) services. By contrast, indications are that wireless assets controlled by the post-merger firm will be bundled with wireline services as "back-up" access or as an additional feature offered with wireline-based subscriptions, nullifying any competitive discipline that could be gained by the presence of wireless access modes in the future.[7]

In short, the AT&T/BellSouth transaction is poised to limit broadband access to one of two types of providers for any given community, the local LEC and the local cable operator. Moreover, for those communities without LEC- or cable-based service, the result is a monopoly provider. Of course, in communities without either, broadband access is simply unavailable.

[7] See, *e.g.*, "BellSouth Introduces Wireless Broadband Product Enhancements," BellSouth News Release, Las Vegas, March 21, 2006, available at: <http://bellsouth.mediaroom.com/index.php?s =press_releases&item=2834> (announcing wireless broadband to permit BellSouth wireline business customers to "back up their existing wireline Internet service").

The parties' argue that a combined AT&T-BellSouth will serve to "check the incumbent cable provider's market power with respect to video programming,"[8] This "countervailing market power" justification is fallacious in general and here it is almost self-evident that a combined AT&T-BellSouth-Cingular program provider in a given locality offers less competitive discipline for an incumbent cable operator than would two or three competitors providing a greater number of alternatives. There is no sound economic justification for the establishment of a duopoly based on the perception that cable operators possess market power, or that only a unitary provider can effectively compete against them.

Question 5.

You mention in your testimony that recent legislative proposals would place broadband service under the exclusive jurisdiction of the FCC. This may have an impact on regulatory decision making, since the legal standards applied by the FTC and the FCC are different; for example, when the FTC evaluates a merger it looks to see if that merger "substantially lessens competition," whereas the FCC evaluates whether that merger is "in the public interest," which is a broader and less defined standard. What are the practical differences you have seen between the FTC and the FCC with respect to preserving competition in content industries, such as video and the Internet, and what differences would you expect to see in telecommunications?

Answer

In light of the on-going transition to a market-based regulatory paradigm, antitrust principles should play a more prominent role in media and telecommunications, not a lesser one. Accordingly, to the extent that conferring exclusive jurisdiction over competition policy in media and telecommunications on the FCC will result in the application of the FCC's "public interest" standard rather than the more competition-specific standards of the Clayton Act, such a change would be seriously ill-advised.

With respect to merger policy, many scholars believe that the present system of sharing responsibility for merger review between a competition authority (FTC or DOJ) and the FCC is dysfunctional.[9] If the present procedure for review cannot be improved significantly, placing the responsibility for merger oversight within the exclusive jurisdiction of a single agency would be one suitable solution.

Proposals that would create exclusive jurisdiction for competition policy in the media and telecommunications industries at the FCC with instructions to apply traditional antitrust standards raise a closer question. In order for such a proposal to make sense, the grant of

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[8]Description of Transaction, Public Interest Showing and Related Demonstrations, Federal Communications Commission, *Applications for Transfer of Control of Domestic Section 214 Authorizations, Applications for Transfers of Control of International Section 214 Applications, Applications for Transfer of Control of Station Licenses and Operating Authorizations*, WC Docket No. 06-74 (filed March 31, 2006), at 27.

[9] See, *e.g.*, Phil Weiser, "Rethinking Merger Remedies: Toward a Harmonization of Regulatory Oversight with Antitrust Merger Review," available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=893072>.

jurisdiction must be accompanied by sufficient appropriations to allow the FCC to establish a competent staff of professional competition attorneys and economists. On the other hand, the FTC already has the competence to discharge such an antitrust function, and enjoys a greater degree of independence as a result of its cross-industrial responsibilities.

Questions of Senator Herb Kohl

Question 1.

Do you share the concerns expressed by critics of the AT&T/BellSouth merger that it will lead to unreasonably high special access rates?

Answer

By all indications, pricing in the special access market nationwide is already unreasonable. Unfortunately, the degree to which AT&T presently constrains BellSouth's special access pricing, a function of the extent to which AT&T offers competitive special access facilities in the BellSouth region, cannot be determined without the benefit of the additional data that has been requested by the FCC but is not yet available. In any event, it is unlikely that the pricing problem in the special access markets will subside without decisive regulatory action in the "pricing flexibility" proceeding presently pending at the FCC.[10] However, the prospect of such action appears unlikely.

Question 2.

As part of their approval of the SBC/AT&T merger, we recommended and both the Justice Department and the FCC approved a number of pro-competition merger conditions. These conditions included offering DSL internet connections to consumers without also requiring them to buy phone service, a requirement that AT&T to divest duplicative overlapping networks, and several others. Do you believe that similar merger conditions should be imposed as a condition of approval of the AT&T/BellSouth merger? Are there additional merger conditions you believe are warranted? If so, describe them and explain why you believe they are necessary.

Answer

While divestiture of overlapping assets may be in principle a sound approach to restoring competition lost through a merger, the implementation of such a remedy through the use of IRUs without also divesting the revenue flow associated with the divested circuits and in the narrow circumstances in which they were imposed in the SBC/AT&T merger is not likely to be effective, for the reasons given in the answer to Question 2 of Senator DeWine, above. With

[10] See Federal Communications Commission, *Special Access Rates for Price Cap Local Exchange Carriers,* WC Docket No. 05-25.

respect to the condition that the post-merger firm offer "naked DSL," the implementation of this condition by the new AT&T has made a mockery of the condition. The *San Francisco Chronicle* reports that AT&T is offering naked DSL at $44.99/month, compared to about $46 for a bundle that includes both DSL and local phone service, a savings to consumers of about $1/month.[11] As a result, these same conditions in connection with the AT&T/BellSouth merger are unlikely to be effective in improving the options facing end-users or remedying the loss of competition resulting from the transaction unless they are linked to some enforcement mechanism to ensure they are meaningfully implemented.

While it is always difficult for an outsider to comment with any real degree of certainty about such a large transaction without the benefit of the resources and information at the disposal of the reviewing competition and regulatory authorities, some general comments nonetheless may be offered.

Conditions designed to remedy the anticompetitive effects of the AT&T/BellSouth merger should be tailored to a particular theory of harm expected to occur in an appropriately defined market. This merger is likely at the least to affect markets in the BellSouth service region for a) mass market broadband access, b) private line services for enterprise customers, and c) any other market, such as long-distance voice services, in which the merging firms may compete directly against one another.

With respect to the mass market for broadband access, for the reasons set forth in the answer to Senator Leahy's Question, below, BellSouth should be required to divest its rights to owned or leased frequencies in the 2.5 Ghz band which are suitable for deployment of WiMAX-powered broadband access. Such a divestiture condition should involve a permanent "fee simple" transfer of rights to a qualified independent acquirer willing to commit to deploying WiMAX broadband access using the divested frequencies throughout the BellSouth service region.

While the parties play down the effect on competition in private line services in the BellSouth region because of only limited competition between AT&T and BellSouth in this segment, the lack of competition and the profits now being earned by incumbents in special access are notorious. The reason for this is primarily because the FCC permitted "pricing flexibility" without first insuring the presence of adequate competition. Special access represents a stubborn "bottleneck" which is held in place in part by pricing and discounting strategies by the incumbents which inhibit switching by customers to competitive carriers. "Price caps" of the type imposed in the AT&T/SBC and Verizon/MCI mergers are only a temporary measure that does not address the root cause of the problem.

Accordingly, traditional divestitures to restore competition lost through the merger (*i.e.*, divestitures that transfer not only circuits but also customers to the acquiring firm) should be

[11] See Ryan Kim, "AT&T offers broadband by itself, Unpublicized DSL service won't save subscribers much," San Francisco Chronicle, June 17, 2006, page C-1.

required in any region or municipality in which the merging parties both have a presence. Moreover, the incumbents should be prohibited from imposing minimum spend levels, quantity-forcing "first dollar" discounts, and other non-linear pricing strategies which exert a stranglehold on their existing customer base.

Question 3.

In your written testimony, you state that antitrust law is "inadequate" to address the issue of net neutrality. What do you mean by this statement? Would repealing the FTC telecommunications common carrier exception aid the ability of antitrust enforcement to address this issue?

Answer

The inadequacy referred to in the statement is the result of the manner in which courts have applied the antitrust laws to industries in transition to market-based models of regulation rather than from any failure of the antitrust laws, as such. Broadly speaking, the difficulty arises when courts fail to recognize that judicial precedent applicable to regulatory regimes that have been repudiated or dismantled cannot continue to be applied to deregulated industries without grotesque results. Entities formerly subject to rate of return regulation, for example, have successfully pressed courts to continue to apply outmoded doctrines as defenses to antitrust claims (such as the filed rate doctrine or common carrier exemptions) while simultaneously exercising freedoms that are gained from deregulation. This problem is particularly acute in the telecommunications and electricity sectors.

Even its most vociferous proponents recognize that net neutrality addresses a competition problem in the internet access market and that a sufficiently competitive market would obviate the need for a net neutrality regulation. The net neutrality issue, therefore, arises largely because the antitrust laws as presently applied have been as yet ineffective in promoting and maintaining adequately competitive telecommunications markets, a condition which extrapolates logically to the market for internet access.

Repeal of the FTC's common carrier exception would assist the courts in appropriately applying antitrust principles when confronted with claims arising in the context of industries formerly regulated as common carriers. Because of the pace in which common carrier regulation is being withdrawn from such industries, however, such an amendment should not be necessary as a technical matter. However, it would certainly place an obstacle in the path of defendants that persist on seeking shelter under such an exception despite the fact that they are operating in newly "competitive" markets.

With respect to the relative merits of FCC or FTC jurisdiction over competition enforcement in the telecommunications industry, please refer to the answer to Question 5 of Senator DeWine, above.

Question of Senator Patrick Leahy

This Committee recently held a hearing on competition in the telecommunications market. You make two interesting observations in your statements – not only is competition currently lacking in the broadband access market, but the spectrum that is best suited for providing wireless competition to the incumbents is being held, but not used, by the incumbents.

The incumbent telephone companies appropriately argue that competition will lead to innovation and lower prices in the video services market. Competition, of course, would also lead to innovation and lower prices in the broadband access market. What policies should this Committee consider to encourage competition and the deployment of new wireless broadband access providers?

Answer

The importance of the broadband access market to American consumers and business end-users cannot be overstated. Technical migration from legacy network platforms to internet protocol- (IP-) based platforms implies that in the near future IP connectivity will provide the underlying mode of access to all telecommunications and media services (with the exception, perhaps, of over-the-air digital broadcasting). As a direct result, IP-based connectivity will soon dwarf all other forms of access in practical importance and economic significance.

Toleration of a duopolistic structure in which local markets are served by at most two providers of broadband access—an incumbent telco and a cable provider—can only serve to hinder progress in broadband penetration in the U.S. and stultify a market that is central to the nation's productivity. Accordingly, policies that promote additional, independent broadband access providers are vital to national welfare and competitiveness.

As the question recognizes, wireless broadband provided by independent network operators (*i.e.*, services <u>not</u> offered as a bundle with wireline or cellular telephone service or even offered by a telco or cable duopolist as a stand-alone offering) represents one of the most promising avenues for alternative competitive broadband access. Unfortunately, BellSouth has been allowed to amass significant spectrum in their southeast region in the 2.5 Ghz frequency band, ideal for "WiMAX" powered wireless broadband access. The term WiMAX stands for "Worldwide Interoperability for Microwave Access," an IEEE 802.16 air interface standard providing broadband wireless technology that supports fixed, nomadic, portable, and mobile access. WiMAX can provide faster data rates than either DSL or cable modem technology.[12]

The control of this spectrum is unfortunate because it functions as a "blocking position" with respect to the build-out of a national-footprint WiMAX network by others, while at the same time the post-merger company will have little or no incentive to roll-out a WiMAX

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[12] See www.wimaxforum.org for further technical information and resources devoted to WiMAX implementations.

platform because it is likely to cannibalize its other broadband services in which sunk investments have already been made.

Specifically, BellSouth owns or controls 28 out of 33 available 2.5 Ghz channels in Atlanta, Georgia, 24 of 33 channels in Jacksonville, Florida, 20 of 33 channels in Louisville, Kentucky, 26 of 33 channels in New Orleans, Louisiana, together with similar capacity in other cities in Florida, such as Orlando, Daytona Beach, Lakeland, and Miami, and in Georgia, such as Rome and Athens.[13]

To be sure, the roll out of a WiMAX broadband access service with a national footprint by a new entrant such as Clearwire would not be technically *impossible* in the absence of divestiture of BellSouth's 2.5 Ghz holdings. The WiMAX Forum standards body and manufacturers of WiMAX equipment may eventually establish standards and offer devices for other frequency bands, in which case a national footprint could be pieced together by, for example, building into devices multiband capability. But such an outcome is likely to require an enormous additional investment and involve a delay that could be as long as several years. These costs, however, dwarf any doubtful benefit of permitting the post-merger company to retain its 2.5 Ghz spectrum, which has remained largely unutilized by BellSouth until recently, despite the company having owned or controlled this spectrum for ten years or more.

Thank you for the opportunity to share my views with the Committee.

Respectfully submitted,

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[13] See Clearwire Corporation Petition to Deny or, in the Alternative, to Condition Consent, Exhibit 1.02, Federal Communications Commission, *Applications for Transfer of Control of Domestic Section 214 Authorizations, Applications for Transfers of Control of International Section 214 Applications, Applications for Transfer of Control of Station Licenses and Operating Authorizations*, WC Docket No. 06-74, (filed June 5, 2006).