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BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Application of	)	
	)	Docket No. UT-050814
VERIZON COMMUNICATIONS, INC., and MCI, INC.	)	
	)	
For Approval of Agreement and Plan of Merger	)	
____________________________________	)	

RESPONSE TESTIMONY OF

DON J. WOOD

on behalf of

XO COMMUNICATIONS SERVICES, INC., and

COVAD COMMUNICATIONS COMPANY

September 9, 2005

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20 PROPOSED MERGER 83

1 **Introduction and Qualifications**
2

3 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**
4

5 A. My name is Don J. Wood. I am a principal in the firm of Wood & Wood, an economic
6 and financial consulting firm. My business address is 30000 Mill Creek Avenue, Suite
7 395, Alpharetta, Georgia 30022. I provide economic and regulatory analysis of the
8 telecommunications, cable, and related convergence industries with an emphasis on
9 economic policy, competitive market development, and cost-of-service issues.
10

11 **Q. PLEASE DESCRIBE YOUR BACKGROUND AND EXPERIENCE.**
12

13 A. I received a BBA in Finance with distinction from Emory University and an MBA with
14 concentrations in Finance and Microeconomics from the College of William and Mary.
15 My telecommunications experience includes employment at both a Regional Bell
16 Operating Company ("RBOC") and an Interexchange Carrier ("IXC").
17 Specifically, I was employed in the local exchange industry by BellSouth
18 Services, Inc. in its Pricing and Economics, Service Cost Division. My responsibilities
19 included performing cost analyses of new and existing services, preparing documentation
20 for filings with state regulatory commissions and the Federal Communications
21 Commission ("FCC"), developing methodology and computer models for use by other
22 analysts, and performing special assembly cost studies.
23 I was employed in the interexchange industry by MCI Telecommunications
24 Corporation, as Manager of Regulatory Analysis for the Southern Division. In this

1 capacity I was responsible for the development and implementation of regulatory policy
2 for operations in the southern U. S. I then served as a Manager in MCI's Economic
3 Analysis and Regulatory Affairs Organization, where I participated in the development of
4 regulatory policy for national issues.
5
6 **Q. HAVE YOU PREVIOUSLY PRESENTED TESTIMONY BEFORE STATE AND**
7 **FEDERAL REGULATORS?**
8
9 A. Yes. I have testified on telecommunications issues before the regulatory commissions of
10 thirty-nine states, Puerto Rico, and the District of Columbia. I have also presented
11 testimony regarding telecommunications issues in state, federal, and overseas courts,
12 before alternative dispute resolution tribunals, and at the FCC. A listing of my previous
13 testimony is attached as Exhibit DJW-1.
14
15 **Purpose and Summary of Testimony**
16
17 **Q. WHAT IS THE PURPOSE AND SCOPE OF YOUR TESTIMONY?**
18
19 A. I have been asked by XO Communications Services, Inc. ("XO") and Covad
20 Communications Company ("Covad") to evaluate the proposed merger between Verizon
21 Communications, Inc. ("Verizon") and MCI, Inc. ("MCI"), collectively the "Applicants,"
22 and to respond to the Applicant's June 28, 2005 testimony in support of the proposed
23 merger.
24 In summary, the Applicants' testimony fails to support the merger in any
25 meaningful way. Instead of providing the information that the Commission needs to

1 conduct a meaningful evaluation of the merger: a precise and meaningful definition of the
2 markets that will be impacted, for each of the identified markets; an analysis of the
3 current concentration and of the concentration that will exist after the proposed merger;
4 and, for those markets with a high concentration, a further analysis of whether the market
5 concentration analysis for each market under- or overstate the likely impact of the
6 merger.

7 Instead of presenting this essential information, Verizon/MCI's testimony is
8 primarily devoted to an effort to end-run accepted and broadly applied anti-trust analysis.
9 The Applicants' witnesses (1) suggest that a meaningful market definition is not
10 necessary, (2) ignore existing processes for calculating pre- and post-merger
11 concentration, and (3) generally engage in a broad effort to divert attention from these
12 shortcomings by describing a litany of purported competitive alternatives that either do
13 not yet exist or exist for some markets, but not others. Finding a multitude of ways to
14 repeat the mantra "cable and VoIP are everywhere, so no market power is possible either
15 now or after the merger" is simply not a substitute for the kind of market-specific and
16 fact-intensive demonstration that the Applicants must provide.

17 In his rebuttal testimony, Dr. Taylor attempts to dissuade this commission from
18 conducting any kind of structured analysis. He fails to utilize the analytical framework
19 relied upon by the Department of Justice ("DOJ") and Federal Trade Commission
20 ("FTC") to determine the negative effects of proposed mergers, and places little or no
21 weight on either previous applications of the Merger Guidelines or common sense about
22 the nature of telecommunications markets in Washington. In my testimony, I will
23 explain why: (1) his failure to consider the importance of the Merger Guidelines renders

1 his analysis useless; (2) the examples that he uses in an attempt to support his faulty
2 conclusions do not demonstrate his case; (3) the merger will have adverse competitive
3 effects in the markets for services provided to (and needed by) mid-sized business users;
4 and (4) he ignores both Verizon's incentives for forbearance and its history of doing so.
5 The fact remains – and the Applicants provide no hard data whatsoever to refute
6 this conclusion – that the proposed merger could lead to a significant reduction in
7 competitive alternatives, an increase in market concentration, and subsequent increase in
8 market power in the markets for mid-sized business customers.[1] The elimination of MCI
9 as an independent retail provider will increase concentration in an already highly
10 concentrated market for these services, and the elimination of MCI as a current and future
11 provider of wholesale building access services, including the needed local loop and
12 transport services, will likely increase prices at the wholesale level. These increases will
13 in turn limit the number of retail competitive options for end-user business customers,
14 and cause an increase in the retail prices paid by these customers in Washington.
15
16 **Q. WHAT IS THE UNDERLYING BASIS FOR YOUR ANALYSIS?**
17
18 A. The Department of Justice – Federal Trade Commission *Horizontal Merger Guidelines*

---

[1] Mid-sized business customers are not identified simply by the absolute size of the business entity, but rather by their telecommunications needs, the services they purchase, and the way that carriers provide these services. They typically require one or more DS1 capacity circuits and purchase their needed telecommunications services locally rather than on a national basis.

1 ("Merger Guidelines" or "Guidelines," 1992, and amended 1997)[2] provide the primary
2 mechanism that should be used to evaluate how the Verizon-MCI merger will affect the
3 end user customers within the different markets for telecommunications services in
4 Washington.
5
6 **Q. WHAT MARKET FACTORS DO YOU IDENTIFY?**
7
8 A. According to the Merger Guidelines, the essential first step of any meaningful merger
9 analysis is the definition of the relevant market. In my testimony, I focus on the effects
10 of the proposed merger on the market for building access services where mid-sized
11 business customers utilize high-capacity access facilities (consisting of loops or loops and
12 transport) at the DS1 level or above to carry either voice or a combination of voice and
13 data. These retail end users acquire these facilities either from Verizon's special access
14 tariffs or from CLECs, including AT&T and MCI. The CLECs, in turn, use their own
15 facilities, use facilities leased from Verizon as special access or unbundled network
16 elements (UNEs), or lease facilities from carriers who offer the facilities to retail
17 providers at wholesale rates.

[2] http://www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.html. A useful example of how the Merger Guidelines should be applied in the two pending ILEC-CLEC mergers (SBC-AT&T and Verizon-MCI) is set forth in the "Department of Public Service Staff White Paper" on the two mergers, released July 6, 2005, in New York Public Service Commission Cases No. 05-C-0237 (Petition of Verizon and MCI) and 05-C-0242 (Petition of SBC and AT&T); ("New York PSC White Paper"). This document and the New York Staff's August 31, 2005 amendment to that report, is attached to my testimony as Exhibit DJW-2.

1 **Q. DO THE APPLICANTS ADDRESS THE IMPACT OF THE MERGER ON THE**
2 **MARKET THAT YOU HAVE IDENTIFIED?**
3
4 A. No. As I explain in more detail later in my testimony, the Applicants have refused to
5 acknowledge that individual geographic and service markets exist, beyond an overly-
6 broad dichotomy of "mass market" and "national and international enterprise" markets.
7
8 **Q. HOW HAVE YOU ATTEMPTED TO EVALUATE THE APPLICANTS' CLAIMS**
9 **REGARDING THE IMPACT OF THE MERGER?**
10
11 A. The Applicants' own cursory and largely anecdotal analysis of the merger[3] contrasts
12 sharply with the types of rigorous economic analyses to which mergers of this scale and
13 scope are usually subjected by relevant authorities such as the U.S. Department of
14 Justice's Antitrust Division ("DOJ"), the Federal Trade Commission ("FTC"), and
15 foreign authorities such as the European Commission. Of course the DOJ and the
16 European Commission, among others, are also evaluating the proposed merger at a higher
17 level, but this Commission's detailed knowledge of conditions within the state makes a

---

[3] For example, Dr. Taylor refers (p. 5) to an increase in investment into critical infrastructure by the post-merger company, but conducts no analysis of the investments that would have been made by an independent Verizon or MCI. Mr. Beach (pp. 31-37) makes various claims regarding the "complementary" natures of the companies' operations and argues that a combined company would be better positioned to respond to market challenges. Unfortunately, his claims are based on the broad "mass market" versus "enterprise" definition of markets, and fail to address how specific markets (identified by product or geography) will be impacted. Dr. Danner states (pp. 16-20) that the merger will permit the combined entity to better meet the needs of "large enterprise customers," but does not address how mid-sized business customers, will be impacted. Dr. Danner also makes a grand claim (p. 6) that "the merger will deliver benefits to customers of all types in the form of competitive prices, improvements to the networks that serve them, and the improved convenience and efficiency associated with the ability to purchase all of their communications needs from a single supplier," but does not specifically address how these benefits will accrue to customers in specific markets. As I explain below, available evidence suggests that customers in at least some markets will not receive such benefits.

1 diligent analysis of the proposed merger's effects on local markets in the state extremely
2 important.
3
4 **Q. DO YOU RECOMMEND ACTIONS THE COMMISSION SHOULD TAKE?**
5
6 A. Yes. The Applicants' provide no information to rebut the assertion that the loss of MCI
7 as a major competitor of Verizon in the market for mid-sized business services and as a
8 wholesale provider of DS1-capacity and above circuits to other competitors of Verizon,
9 particularly when considered together with the loss of AT&T in some or all of this
10 market, that will materially reduce competition and adversely affect end user customers.
11 If the merger is not to be rejected outright, as it should be, it is critically important that
12 the Commission fashion conditions that will help ensure that Verizon's remaining
13 competitors in the business market are able to survive and compete.
14 My testimony describes several steps that the Commission should take to mitigate
15 the adverse price impacts from the merger. I discuss how and why the Commission
16 should ensure independent CLECs have stability in their contracts and dealings with
17 ILECs such as Verizon. These non-exclusive conditions should be imposed for a
18 minimum of five (5) years after each proposed merger transaction is completed.
19 **The Commission Should Use the DOJ-FTC Merger Guidelines as the Primary Framework**
20 **for Evaluating the Proposed Merger**
21
22 *Description of the DOJ-FTC Merger Guidelines*
23 **Q. HOW SHOULD THE COMMISSION EVALUATE THE PROPOSED VERIZON-**
24 **MCI MERGER?**
25
26 A. The Commission should, of course, evaluate the merger using the policies and state-

1 specific factors that it has applied to other mergers. However, the impact of the proposed
2 merger on competition in Washington must be a central feature of the Commission's
3 analysis. The most effective means of evaluating this critical factor will be to apply the
4 standard tests summarized in the Department of Justice – Federal Trade Commission
5 *Horizontal Merger Guidelines* (the "Merger Guidelines" or the "Guidelines"). The
6 guidelines describe the tests for (1) defining relevant markets, (2) measuring the degree
7 of concentration in the markets before and after a proposed merger, (3) identifying likely
8 adverse effects from a merger, described either as unilateral effects (such as price
9 increases) or coordinated effects (a resulting change in market structure), (4) determining
10 whether firms other than the merging parties could enter the relevant market to compete
11 and whether such firms would be mere fringe competitors or would be able to expand
12 their competitive presence in order to discipline the prices and conduct of the newly
13 merged firm, and (5) analyzing whether the merged firm would enjoy such increased
14 efficiencies that the merger should be approved regardless of deficiencies in the other
15 areas.[4]

16 Analysis using the Merger Guideline tests determines whether there are sufficient
17 substitute facilities actually available or capable of being made available in the relevant
18 markets, so that "small but significant and nontransitory" price increases could not be

---

[4] The Guidelines also discuss analytical frameworks for evaluating mergers involving one or more failing firms, an issue which is not relevant, given the bidding war over MCI in which Verizon and Qwest engaged.

1 successfully imposed.[5] Substitute facilities that might become available when a
2 competing supplier enters the market are counted only if "timely and likely entry would
3 be sufficient to return market prices to their premerger levels."[6]
4
5 **Q. DO THE VERIZON/MCI WITNESSES PROVIDE ANY ANALYSIS BASED ON**
6 **AN APPLICATION OF THE MERGER GUIDELINES?**
7
8 A. Not only do they not provide the market-specific and fact-intensive analysis that the
9 Commission needs in order to evaluate the effects of the proposed merger on Washington
10 ratepayers, I can find no reference to the Merger Guidelines at all in the testimony of Dr.
11 Danner or Mr. Beach, and only a cursory reference in the testimony of Dr. Taylor (p. 81)
12 that is not accompanied by any analysis.
13
14 **Q. WHY SHOULD THE MERGER GUIDELINES BE THE STANDARD FOR**
15 **EVALUATING THE COMPETITIVE EFFECTS OF THIS MERGER?**
16
17 A. The Guidelines encapsulate an analytical framework recognized not only by the DOJ and
18 the FTC but by antitrust regulatory authorities in most developed nations, including the
19 European Union.[7] The Guidelines have proven over many years to be a rigorous method
20 for evaluating the probable competitive – and anticompetitive – consequences of a
21 horizontal merger. It is entirely feasible to analyze the effects of the proposed Verizon-

---

[5] Merger Guidelines § 1.0

[6] *Id.*., § 3.0

[7] For a celebration of 20 years of merger analysis using the Merger Guidelines, see http://www.usdoj.gov/atr/hmerger.htm.

1 MCI merger under the standard tests, as the New York PSC White Paper demonstrates.[8]
2 I address the effect of the proposed merger on Washington markets for high-capacity
3 access to customer premises at a DS1 capacity level or higher, considering the
4 provisioning of retail alternatives but emphasizing the provision of wholesale alternatives
5 to Verizon's offerings of unbundled network elements ("UNEs") and special access
6 services.
7

8 *An Accurate Market Definition is an Essential First Step in the Required Analysis*

9 **Q. CAN YOU DESCRIBE IN MORE DETAIL THE MERGER GUIDELINES'**
10 **CRITERIA FOR DEFINING RELEVANT MARKETS?**
11
12 A. Yes. As the Merger Guidelines make clear, developing an accurate and meaningful
13 market definition is the essential first step of any antitrust merger analysis. Any
14 discussion of the competitive effects of a merger that is not based on a working definition
15 of the relevant geographic and product market is meaningless.[9] Market definition is a
16 rigorous, quantitative exercise, based on an analysis of consumers' ability to satisfy their

---

[8] The results of the diligent and comprehensive analysis performed by the New York PSC Staff should be considered by the Commission in this proceeding. Because the results are based on the geographic area that has the highest concentration of competitive alternatives (and therefore the *lowest* market concentration) of any location in Verizon's service area, the results of the New York PSC Staff White Paper represent the best-case scenario regarding the proposed merger's impact on market concentration and the resulting increase in market power. That is, it is reasonable to conclude that impact of the proposed merger in Washington will be worse than (or at best equal to) the impact identified in New York.

[9] Specifically, the Guidelines state: "The analytic process in this section ensures that the Agency evaluates the likely competitive impact of a merger within the context of economically meaningful markets – i.e., markets that could be subject to the exercise of market power." Merger Guidelines, §1.0

1 demand for a product in a geographic area, by using *substitutes* for the merging firms'
2 outputs.
3 Pursuant to the Merger Guidelines, product or service markets are defined by the
4 likely pricing behavior of a hypothetical entity that has a monopoly in that product
5 market. The test is whether the hypothetical monopolist would be able to impose a
6 relevant price increase (as defined below) for the products in the market. If the
7 monopolist could profitably impose a price increase on a single product, then possible
8 substitute products are by definition not sufficient to constrain prices and are not in the
9 same relevant market. In other words, the monopolist could impose its increase because
10 consumers lack adequate alternatives or substitutes. If on the other hand, the relevant
11 increase could not be sustained in the product market as defined, the market definition
12 must be expanded to encompass the substitute products. Finally, if the monopolist (now
13 having an assumed monopoly in both the product originally subject to the test and the
14 substitute product(s) that have been added to the revised definition) can still increase its
15 prices as defined, that set of products becomes the relevant market. The analysis is
16 reiterated as necessary until the definition embraces all products or services that are
17 effective substitutes for each other. The final list comprises the relevant market.
18 A significant portion of the Guidelines is devoted to market definition: "the
19 analytic process described in this section ensures that the Agency evaluates the likely
20 competitive impact of a merger *within the context of economically meaningful markets*,"
21 and markets are defined in terms of both "a product or group of products" and a

1 "geographic area."[10] The Guidelines go into considerable detail regarding the definition
2 of these "economically meaningful markets" in terms of the product (§1.1) and
3 geographic area (§1.2). Establishing an economically meaningful market definition is an
4 essential prerequisite to the next steps of identifying "firms that participate in the relevant
5 market" (§1.3), "calculating market shares" (§1.4), and evaluating "market
6 concentration" both pre- and post-merger (§1.5). Without first establishing a meaningful
7 market definition, the process of identifying market participants (suppliers or potential
8 suppliers) cannot be done accurately; any effort to calculate market shares will be a
9 fruitless exercise because the list of suppliers may be significantly under- or over-
10 inclusive; and no reliable measures of market concentration can be made.

11 *The Applicants' failure to develop and apply the necessary market definitions*
12 *represents an error that permeates their entire presentation and that compounds with*
13 *each step of the five step process set forth in the Merger Guidelines.* Without a working
14 definition of the market to be analyzed (in terms of product and geography), it is
15 impossible to accurately identify the relevant market participants and therefore
16 impossible to develop any meaningful measure of whether the concentration will "create
17 or enhance market power" or "facilitate its exercise."

18 In summary, the basic framework for a real market definition must examine
19 demand substitution effects. If a particular product can be substituted for another, then
20 those two products are considered to be in the same market. In contrast, products that
21 cannot now be substituted, *even if an expectation exists that changes or further*

[10] Merger Guidelines, §1.0, emphasis added.

development of technology at some point in the future may make such substitution possible, are not part of a single defined market.

Q. WHAT ABOUT THE GEOGRAPHIC DEFINITION OF THE MARKET?

A. Unlike typical markets for physical products, the definition of a market for telecommunications services has a critical geographic component. It does not simply depend, as the market for a physical product might, on whether and at what cost an item could be shipped from one locale to another. Instead, in order to utilize a telecommunications service the customer must have access to a facility *at the time and at the location where the customer wants to make the call*. While a "nearby" substitute is not part of the immediately relevant geographic market, the possibility of a nearby substitute becoming actually available at the customer's specific location should be evaluated.

Q. WHAT IS THE RELEVANT GEOGRAPHIC MARKET?

For building access provided to mid-sized business customers, the definition of the geographic market must consider the individual buildings, campuses and individual end user locations where an effective substitute product would need to be present in order for a given customer to make use of it. The ability of substitute products to impose price discipline in the market also depends on aggregate end user demand *at a given location or for a given facility*.

1 *The Impact of the Proposed Merger on Mid-Sized Business Customers Must Be*
2 *Evaluated*
3 **Q. HAVE YOU APPLIED THE MERGER GUIDELINES CRITERIA WHEN**
4 **DEFINING THE MARKET FOR PROVIDING SERVICES (INCLUDING LOOP**
5 **AND TRANSPORT FACILITIES) TO MID-SIZED BUSINESS CUSTOMERS?**
6
7 A. To be clear, the term "mid-sized" refers to the customer's demand for
8 telecommunications services, rather than of the size of the business entity itself, because
9 this is a more meaningful indicator of the kinds of telecommunications services that
10 should be analyzed. Some relatively small businesses with intensive telecommunications
11 needs should properly be considered mid-sized, as should a larger business entity with
12 relatively light telecommunications needs. An additional consideration is the fact that
13 many relatively large businesses, even those that have multiple locations, nevertheless
14 purchase telecommunications services locally (that is, by location) rather than pursuant to
15 a regional or national contract.[11] The key distinction is that this group of business
16 customers requires high-capacity services to their respective location or locations, and
17 they purchase these services on a local basis.
18 The demand substitution test confirms that the mid-sized business market is a
19 discrete, relevant market. It is geographically localized and it has a different technology
20 basis and different product requirements than the mass market (it typically requires DS1-
21 level or higher access facilities, while the mass market is based on voice-grade facilities).
22 In comparison to the market for telecommunications services provided to very large
23 business customers with a national or international scope (so-called "enterprise"

---

[11] There are many potential reasons for buying services on a local basis. The competitive alternatives available to the customer may vary by location, the customer's locations may be spread across more than one ILEC service area, or the total volume required by the business may not meet a carrier's threshold amount to qualify the customer for a more comprehensive contract.

1 customers), the mid-sized business market has different price and service requirements.
2 Typically, very large business customers are characterized by multiple locations,
3 specialized product needs, and often specialized contracts with service providers that
4 cover multiple locations. In contrast, mid-sized businesses may have a single or
5 relatively small number of locations and purchase the services they need at a local level.
6 They rarely receive specialized treatment (committed account representatives, for
7 example) and usually do not obtain customized contracts or service arrangements, but
8 instead buy from available suppliers at tariffed rates. Thus, a "small but significant non
9 transitory price increase" by a firm with market power in the mid-sized business market
10 would not be defeated by customers substituting a service offered by suppliers operating
11 in the large business or residential markets.

12 As I discuss later in more detail, to the extent the mid-size business market has
13 substitutes, they exist only within the product markets for wireline telephony. If the
14 additional market concentration that would be created by the proposed merger is
15 permitted, no technological substitute exists to prevent an enhancement of market power
16 or to prevent the new combined company from successfully raising prices in this market.
17 As I explain in detail later in my testimony, mobile wireless services, fixed wireless
18 services, cable systems, and new switching platforms like Voice over Internet Protocol
19 ("VoIP") simply do not represent competitive alternatives for DS1-level and above loops.
20 Because there are no intermodal competitive alternatives to these wireline circuits, retail
21 competition in the mid-sized business market – where it exists – comes from wireline
22 CLECs. In most markets, the largest and most ubiquitous CLEC competitors (at least

1 pre-merger) are AT&T and MCI. The elimination of these competitors will directly
2 impact the availability of both wholesale and retail competitive alternatives.
3

4 **Q. DO THE APPLICANT'S ACKNOWLEDGE THAT THIS MARKET EXISTS?**
5
6 A. No. Instead, the Applicants' witnesses attempt to ignore meaningful market definitions if
7 such accuracy gets in the way of their sweeping claims regarding ever-present
8 competitive alternatives. For example, Mr. Beach (p. 30) states – with no supporting
9 analysis whatsoever – that "the market for medium-sized businesses is not very different
10 from the market for large enterprise customers." He is demonstrably wrong in two ways.
11 First, not all business customers purchase telecommunications services in the volumes
12 assumed by Mr. Beach, and it is absurd to suggest that all business customers are
13 "targeted" in the same way and to the same degree by carriers in their marketing efforts.
14 Second, Mr. Beach ignores the geographic element of market definition. The demand of
15 these customers is location-specific, and the competitive alternatives are not equally
16 available at all such locations.
17

18 **Q. IS THE APPLICANTS' TREATMENT OF ALL CUSTOMERS BEING EITHER**
19 **"MASS MARKET" OR "ENTERPRISE" CONSISTENT WITH HOW EACH**
20 **COMPANY ACTUALLY PROVIDES SERVICE?**
21
22 A. No. When constructing its website, Verizon apparently found it both possible and useful
23 to make such distinctions. Potential customers visiting Verizon's website
24 (www.Verizon.com) who wish to determine which Verizon services are likely to meet
25 their needs are invited to different service descriptions depending on whether the
26 customer is a "small business," "medium business," or "enterprise and large business"

1 customer. Potential “small business” customers are taken to a page that contains the
2 essentially the same service options as those offered to residence customers (though in a
3 slightly different format). Potential “large/enterprise” customers are taken to a page that
4 describes the *Verizon Enterprise Solutions Group* that manages the design, operation and
5 maintenance of end-to-end integrated network solutions for large business, government
6 and education customers across the United States, has more than 7,800 employees in 35
7 states, offers a complete range of basic and advanced communications products and
8 services to meet the voice, video, data and IP-related requirements of its customers, and
9 touts over 5,200 field operations personnel to support enterprise customers nationwide.
10 In contrast to the “small business” and “large enterprise” business pages, potential
11 mid-sized business customers are taken to a page that describes T-1 services (not
12 referenced on the small business or residence service pages), but that says nothing about
13 a dedicated group to take care of customers with locations across the country, integrated
14 network solutions, or service packages to meet a customer’s “voice, video, data and IP-
15 related requirements.”[12]
16
17 **Q. HAS MCI MADE SIMILAR DISTINCTIONS ON ITS WEBSITE?**
18
19 A. Yes it has. I have attached printouts of portions of MCI’s website as Exhibit DJW-3 to
20 illustrate that the company targets small, mid-sized, and enterprise customers separately.

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[12] Copies of the referenced pages, current as of August 25, 2005, are attached as Exhibit DJW-2.

1 **Q. DR. TAYLOR (P. 50) ARGUES THAT THE PRESENCE OF INTERMODAL**
2 **COMPETITION RENDERS THE KIND OF MARKET SHARE ANALYSIS**
3 **THAT YOU DESCRIBE OBSOLETE. DO YOU AGREE?**
4
5 A. Absolutely not. Dr. Taylor's testimony here is yet another example of the Applicants'
6 attempt to blur all market distinctions in order to hide the fact that the proposed merger
7 *will* have adverse effects for customers in many telecommunications markets within the
8 Verizon region. There are at least three reasons why Dr. Taylor's attempt to have any
9 meaningful analysis eliminated from the proceeding should be rejected.
10 First, Dr. Taylor's testimony, which considers only projected, rather than existing,
11 market shares to analyze the effects of the proposed merger, is inconsistent with the
12 actual language of the Merger Guidelines. Dr. Taylor may be confusing §1.41 of the
13 Guidelines, which deals with the question of whether to measure market share in terms of
14 dollars generated or units sold: "market shares will be calculated using the best indicator
15 of the firm's competitive significance. Dollar sales or shipments will generally be used if
16 firms are distinguished primarily by differentiation of their products. Unit sales generally
17 will be used if firms are distinguished primarily on the basis of their relative advantages
18 in serving different buyers or groups of buyers." §1.41 does *not* address the question of
19 whether it is appropriate to measure existing market share or to speculate regarding future
20 market share, but rather addresses the question of whether to measure market share in
21 terms of dollars generated or units sold. Considering, §1.41 of the Guidelines I do not
22 believe there is any foundation for his entirely forward-looking perspective.
23 Second, "intermodal" and nascent technology-based competition for mass market
24 customers in some areas cannot be relied upon as a foundation for assuming that mid-
25 sized business customers have access to the same competitive alternatives for the services

1 that they need. As I explain in detail later in my testimony, mobile wireless, cable, VoIP,
2 or WiMax services, even where available, do not and cannot represent a viable substitute
3 for the high-capacity wireline facilities that mid-sized business customers rely upon.
4 Third, Dr. Taylor's suggestion of pervasive dynamic technological change is
5 over-broad. The claims of dynamic change simply do not apply to the DS-1 capacity
6 facilities relied upon by mid-sized business customers. The technology and facilities
7 used to provision these circuits has not changed for decades, and none of the alternative
8 technologies listed by the Applicants in their testimony represent a viable technical
9 substitute for these facilities. In addition to the static nature of the technology used, the
10 dominance of the ILECs has similarly not changed in any significant way. AT&T and
11 MCI, after investing billions of dollars in infrastructure, have managed to capture only a
12 small fraction of this market, and no other provider – using any technology – has
13 established a more significant presence.
14 For these reasons, any meaningful analysis of the market for mid-sized business
15 customers must be based on the existing technology used to provide these services (as no
16 alternative technology has been identified, much less actually deployed on a wide scale)
17 and must consider the market concentration that will exist post-merger. The process of
18 citing numerous anecdotal examples of "intermodal" alternatives for customers with
19 fundamentally different needs is no substitute for this analysis.

1 *The DOJ-FTC Merger Guidelines Should Be Used to Evaluate the Impact of the*
2 *Proposed Merger on Concentration in Individual Markets*

3 **Q. CAN YOU DESCRIBE HOW THE MERGER GUIDELINES ARE USED TO**
4 **EVALUATE MARKET CONCENTRATION?**
5
6 A. Yes. The Guidelines estimate the degree of concentration in the (now-defined) market
7 among relevant suppliers, using the Herfindahl-Hirschman Index ("HHI"). The HHI is
8 calculated by adding the squares of the market shares of suppliers in the relevant market
9 of the top four suppliers. The Guidelines divide "the spectrum of market concentration as
10 measured by the HHI into three regions that can be broadly characterized as un-
11 concentrated (HHI below 1000), moderately concentrated (HHI between 1000 and 1800)
12 and highly concentrated (HHI above 1800)."[13] While mergers in less concentrated
13 markets are deemed worthy of further analysis if the HHI increases by more than 100
14 points, the Guidelines note that "Mergers producing an increase in the HHI of more than
15 50 points in highly concentrated markets post-merger potentially raise significant
16 competitive concerns."[14]

17 An analysis of the effects of concentration requires both current and forward-
18 looking information.[15] Therefore, a specific market cannot be properly analyzed merely
19 by looking at recent ILEC line losses, wireless and cable subscriber gains in one market
20 (such as the mass market), or information that relates solely to market size. Nor can this

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[13] *Id.*., § 1.5

[14] *Id.*., § 1.51(c).

[15] The change in market shares of Verizon and other providers over time can provide useful data about costs of and barriers to market entry and expansion. The Merger Guidelines do not state that concentration above a certain level is *ipso facto* the end of the analysis but instead represents a guide to structure the overall application of the framework.

1 analysis simply estimate the market shares enjoyed by various classes of suppliers or
2 technologies. Quantitative data bearing on the size and scope of competition and the
3 existence of possible substitutes must be carefully analyzed, using the Merger Guidelines
4 as the proper tool for doing so.

5 The market for Verizon's high-capacity loop and transport services is highly
6 concentrated, and in the market consisting of mid-sized business customers, the primary
7 loop buyers are IXCs and CLECs. Verizon's high market shares combined with MCI's
8 share as the second or third largest alternative supplier means that the proposed merger
9 far exceeds the Guideline standard of market concentration by any measure, and thus is
10 now subject to careful, additional scrutiny by DOJ and the FCC.

11

12 **Q. DOES AVAILABLE EVIDENCE SHOW A HIGH DEGREE OF RISK THAT**
13 **THIS MERGER WILL CONSTRAIN COMPETITION IN THE MARKET FOR**
14 **MID-SIZED BUSINESS SERVICES?**

15

16 A. Yes. The Staff of the New York Public Service Commission gathered data to calculate
17 HHIs for "enterprise customers located primarily in New York State.[16] Using revenue
18 share data for the overall enterprise market – which includes larger customers as well as
19 small to mid-sized business customers, the Staff concluded:

20 > Our analysis indicates that the HHIs [for the enterprise market in
21 > New York] increase by 1,755 from a base before the merger of
22 > 2,924 to a post-merger HHI of 4,679. These HHIs would clearly
23 > exceed the DOJ Merger Guidelines threshold and indicate a
24 > precipitous increase in market concentration.[17]

25
26

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[16] New York PSC White Paper, p. 29.

[17] Id.

1 **Q. HAVE REGULATORS IN ANY OTHER STATES IN THE VERIZON REGION**
2 **CONDUCTED A SIMILAR ANALYSIS?**
3
4 A. Yes. The Staff of the Virginia State Corporation Commission, after conducting its
5 analysis, concluded that "the Staff is not convinced that the Petitioners have met their
6 burden of proof for the Commission to be satisfied that "adequate service to the public at
7 just and reasonable rates will not be impaired or jeopardized by the proposed merger."[18]
8 The Staff went on to conclude that the Virginia Commission could either reject the
9 petition outright or approve the petition "subject to the appropriate conditions that ensure
10 adequate service to the public at just and reasonable rates will not be impaired or
11 jeopardized."
12
13 **Q. BASED ON THE INFORMATION PROVIDED BY THE APPLICANTS, DOES**
14 **THIS COMMISSION HAVE THE ABILITY TO REACH THIS KIND OF**
15 **INFORMED CONCLUSION?**
16
17 A. Unfortunately, no. While available information suggests that the Commission should
18 have concerns similar to those expressed by the Virginia Staff and Attorney General of
19 New York,[19] it does not yet have the information necessary
20

[18] Staff Report, Virginia State Corporation Commission Case No. PUC-2005-00051, August 12, 2005, p. 33.

[19] See Comments of Attorney General of the State of New York on the Department of Public Service Staff White Paper, August 5, 2005.

1 *The DOJ-FTC Merger Guidelines Should Be Used to Evaluate the Possible Adverse*
2 *Effects of the Proposed Merger on End-User Customers*
3 **Q. HOW DO THE GUIDELINES DETERMINE POSSIBLE ADVERSE PRICE**
4 **EFFECTS RESULTING FROM A MERGER?**
5
6 A. The analysis asks whether or not a merger could result in potential adverse competitive
7 effects including a "small but significant and nontransitory" price increase (with a 5%
8 permanent price increase used as an initial benchmark – subject to other analyses).
9 Due to the lengthy time it takes for providers to respond to price changes, the
10 reality of "nontransitory" price increases is particularly clear with respect to the market
11 for building access (loop and transport) services. Where a substitute service does not
12 exist, a price increase with adverse effects on end users can be sustained as long as it
13 takes a substitute provider to: (1) identify customers who will use the access facility and
14 provide a revenue stream to offset the required capital expenditure, (2) allocate capital to
15 build the facility, (3) internally and externally plan and permit all necessary processes
16 (for example in municipalities with control over rights of way and in buildings where
17 owners control access), and (4) actually build and equip the facility. While some of these
18 steps may overlap, there is no real argument that the time and fixed (and sunk) costs
19 required for a substitute provider to complete the physical provisioning of building access
20 facilities demonstrates that this market can sustain significant nontransitory price
21 increases for a considerable period of time. Considering the fact that in many cases
22 thousands of individual end user locations must be addressed in order for the substitute
23 competitive product to be an effective constraint against price increases, the magnitude of
24 the problem becomes clear.

1 **Q. ARE NON PRICE-RELATED ADVERSE EFFECTS RECOGNIZED BY THE**
2 **GUIDELINES?**
3
4 A. Yes. Adverse competitive effects are usually categorized as "unilateral" effects (results
5 that occur solely because of conditions pertaining to the merged firms) and "coordinated"
6 or "collusive" effects (results that may occur due to conditions arising from the
7 interaction of the merged firm with other firms in the same industry). The substantial
8 body of literature about possible coordinated effects in markets (with or without a
9 pending merger) is especially notable given the parallel proposed merger of SBC and
10 AT&T alongside of Verizon and MCI. A scenario that involves the simultaneous
11 combination of (1) the second-largest supplier of local services with the largest long
12 distance supplier and local competitor, and (2) the largest supplier of local services with
13 the second largest long distance and local competition company, is unprecedented. A
14 merger that will undoubtedly cause major changes to multiple telecommunications
15 markets requires that a detailed economic analysis be conducted before possible adverse
16 coordinated effects can be dismissed.
17 If firms have the incentives and information necessary to devise strategies of
18 limiting competition between each other and then undertake to limit that competition, the
19 result is mutual forbearance. If a merger will cause an increase in market concentration
20 that can be expected to facilitate mutual forbearance, that potential is a reason to
21 seriously question and possibly (with other factors being taken into consideration) to
22 reject the merger. The issue of mutual forbearance is particularly significant considering
23 that the proposed Verizon-MCI merger is being paralleled by the SBC-AT&T
24 combination.

As I discuss below, the likely outcome of the two mergers will be mutual forbearance from competing in loop and local transport markets for mid-sized business customers, in spite of the claims made by the Applicants. There are at least two reasons why I believe this to be the case. First, the ILECs have a history of such conduct. Second, mutual forbearance is the economically rational solution for the merged firms. One way to avoid this tacitly collusive outcome would be for Verizon and SBC to build local facilities throughout each other's territories; an outcome that is highly unlikely given the high costs of this buildout and the advantages that each has in its home territory.

The DOJ-FTC Merger Guidelines Should Be Used to Evaluate the Impact of the Proposed Merger on Market Entry and Expansion

Q. HOW IMPORTANT ARE ISSUES RELATED TO THE ECONOMICS OF MARKET ENTRY AND EXPANSION?

A. Very important. The Guidelines require analysis of whether entry into the market(s) by new firms or an expansion of the competitive presence in the markets by existing firms would be sufficient to counteract any adverse competitive effects arising from a merger. This analysis must consider factors related to both the likelihood and timing of such potential entry or expansion.

The Merger Guidelines examine whether entry conditions reasonably suggest that a new firm could enter a particular market in which a merger is proposed (or in a market that is characterized by a limited number of potentially competing firms) and what economic factors would hinder or stimulate the expansion of those firms such that they would discipline the pricing and other behavior of the merging companies.

Available Evidence Strongly Suggests that Entry Barriers Exist to the Market for Mid-Sized Business Services

Q. HAVE YOU CONDUCTED SUCH AN ANALYSIS, AND IF SO, WHAT ARE ITS RESULTS?

A. I was unable to conduct a detailed analysis of entry and exit costs due to information limitations. Of course, it is well within the power of the Commission to require that such an analysis be conducted and produced by the Applicants.

Information is available that illustrates the Commission's need for further information. In 2004 the ILECs' realized rate of return on special access was over 30%. These returns are based on the ILECs' embedded costs; so the margins based on an economic measure of their costs would be significantly *greater* than 30%. The existing pricing of Verizon's and other ILECs' special access services strongly suggest that significant barriers to entry in this market do persist because the ILECs do set prices above a relevant measure of incremental cost and persistently earn returns that include large rents.

Q. IS THERE ANY OTHER INDEPENDENT EVIDENCE THAT COMPETITIVE ENTRY IS SUBJECT TO SIGNIFICANT ENTRY AND EXPANSION BARRIERS?

A. Yes, the existence of such barriers can be seen in FCC data on local competition. When considered only at a superficial level, summaries of the FCC's findings appear to show that CLECs have made significant inroads in taking share from ILECs, but this is misleading. In Washington the CLEC share was most recently reported as 14%. However, the share of lines actually owned end-to-end by CLECs in Washington was less

1 than 4% of all reported lines in the state (CLEC and ILEC) in June 2004.[20] FCC national
2 data shows that fully 74.4% of the lines the FCC counted as "CLEC" lines were in fact
3 provided through UNE-P arrangements (that will no longer be available) or through total
4 service resale (that reflect no CLEC loop investment).[21] After nearly a decade of
5 competition, CLEC facilities serve less than 4% of the Washington market overall,
6 despite massive capital expenditures. [22] This result is fully consistent with the existence
7 of significant barriers to entry and expansion.

8 It is also important to consider that additional entry barriers exist for the carriers
9 seeking to deploy the high-capacity loop and transport facilities necessary to provide
10 building access services to mid-sized customers. As an initial condition, these carriers
11 must have the capital resources needed to engage in such a construction plan. Even when
12 they have the necessary resources, these carriers must go through an extended process of
13 obtaining municipal permits, coordinating with other utilities and with the ILEC, and
14 actual construction (and must retain the customer throughout this process, even while the
15 customer is subject to the "win-back" offerings of the ILEC). In addition, evidence
16 presented in various state TRO proceedings suggests that in many cases building owners
17 act to prevent access by carriers other than ILECs. Finally, a barrier exists because in
18 order to justify the construction of a given high-capacity facility, a carrier must have

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[20] FCC Local Competition Report, December 2004, Table 6 (End User Switched Access Lines served by Reporting Local Exchange Carriers by State); and Table 10 (CLEC-Reported End User Switched Access Lines by State) as of June 30, 2004. http://www.fcc.gov/wcb/iatd/comp.html

[21] *Id.*, Table 4.

[22] These are statewide numbers, and Verizon serves less than one third of the total access lines in Washington. I understand that Commission Staff has estimated that competitors serve a total only 3% of the access lines in Verizon's ILEC service territory, which would make the 4% statewide figure of wholly facilities-based CLEC lines far too high.

1 customer demand at that location that is sufficient to make the investment feasible (or, as
2 discussed in more detail later in my testimony, the ability to sell the excess capacity on
3 wholesale basis).
4

5 **Verizon and MCI Have Ignored the *Merger Guidelines* When Attempting to Support the**
6 **Proposed Merger**
7

8 *The Applicants Have Failed to Conduct an Appropriate Merger Analysis*
9 **Q. HAVE THE APPLICANT'S ATTEMPTED TO SHOW THAT THE PROPOSED**
10 **MERGER IS IN THE PUBLIC INTEREST?**
11
12 A. Yes and no. The Applicants produced three witnesses to attempt to justify the merger as
13 proposed. Dr. Carl Danner discusses telecommunications markets and emerging
14 technologies generally; Dr. William Taylor offers a more expansive but still very general
15 discussion of telecommunications markets; and Mr. Michael Beach of MCI describes the
16 recent factors and trends that led to MCI's decision to pull out of the mass market.
17 Dr. Taylor best advances the applicants' primary argument but ultimately
18 concludes only that a more detailed discussion of the merger in specific markets need *not*
19 be undertaken.[23]

---

[23] "The current view of the competitive landscape should account for all forms of communications and technologies, without regard to regulatory classification or wireline service legacies. Because the competitive landscape has been transformed from a set of separate industries individually providing local and long distance services into converged providers that are competing to offer a wide range of services, the post-transaction company will compete not in individual, historical markets such as local voice services, but for overall services provided to residential, small business, and enterprise customers." Testimony of Dr. William E. Taylor, pp. 48.

1 **Q. DO YOU AGREE WITH DR. TAYLOR'S CONCLUSION?**
2
3 A. No. Such an approach is overly simplistic; consumers do purchase products in one
4 specific, individual market and not in others and *competitors* do often compete in some
5 markets but not in others, such as the market in which facilities of with the capacity
6 needed to serve mid-sized business customers are used.[24] Fortunately, the approach of
7 glossing over certain relevant portions of a full merger analysis has not been sufficient to
8 satisfy federal regulators.[25]
9 Mr. Beach discusses MCI's "irreversible decline" in the mass market, but pays
10 little attention to other markets served by MCI. This oversight is unfortunate, because as
11 Dr. Danner notes, MCI "has a global fiber optic long-distance network and global data
12 capabilities that include private line and packet-switched data services such as ATM and
13 Frame Relay. In addition, MCI has an extremely valuable and extensive IP-based
14 backbone network and related expertise."[26] I agree, and believe that the Commission
15 should analyze the ways in which the merger might affect all markets.

---

[24] Dr. Taylor and Dr. Danner seem to be at odds on this issue. Dr. Taylor claims (p. 53) that mid-sized business can be grouped with large enterprise customers, stating that "the Board should analyze competition for two customer segments: residential/small business customers (which I call the "mass-market" customers); and large and medium-sized business customers (which I call "enterprise customers"), while Dr. Danner suggests (p. 20) that these customers buy services in significantly different ways, stating that many medium-sized business customer buy "sophisticated communications solutions" similar to "large enterprise customers," while some "buy 'off the shelf' solutions."

[25] The FCC required Verizon and MCI to develop much more specific market definitions and analyses with separate information for local voice, local data, interexchange international voice, interexchange and international data, converged voice and data, systems integration/managed services, equipment, and other. See, "Verizon, MCI Respond to FCC with Net Revenue, Traffic Data," TR Daily July 11, 2005.

[26] Testimony of Dr. Danner, p. 18.

1 **Q. CAN YOU COMPARE VERIZON'S AND MCI'S MERGER ANALYSES WITH**
2 **THE MERGER GUIDELINES?**
3
4 A. No such comparison is possible because Verizon and MCI have chosen to argue, in
5 effect, that virtually every telecommunications product or customer market is basically
6 interchangeable with all others and that any and all previous distinctions no longer apply.
7 This argument is premised on some of the changes that have occurred over the past
8 decade.[27] While the widespread availability of commercial wireless services (at least in
9 urban areas), the growth of the Internet, and increased penetration of broadband facilities
10 are certainly significant developments, and while, the emergence of nascent technologies
11 like VOIP have received attention in both popular and industry press,[28] these general
12 observations do not substitute for a proper market-based analysis. Acknowledging the
13 existence of such changes in no way addresses the question of which specific markets are
14 affected by some, all, or none of these developments. Much of Verizon's and MCI's
15 presentation is focused on either end of the scale: at one end the mass market, and at the
16 other end large enterprises.[29] What they fail to recognize is that each market has
17 characteristics that must be analyzed individually. The type of anecdotal presentation the
18 Applicants have introduced is no substitute for application of the merger guidelines, and
19 the nature of the Applicants' showing is one likely reason that federal regulators have
20 sought volumes of additional information.
21 As proponents of the merger, Verizon and MCI have an obligation to address
22 these issues and rigorously apply the Merger Guidelines. The companies have the data

[27] See Dr. Taylor's discussion of "convergence," pp. 45-49.
[28] See Taylor Direct, 45-46.
[29] See Taylor Direct, 45-46.

1 necessary to properly gauge the effects of the proposed merger and the Commission
2 should require the analysis to be conducted. The Applicants make various arguments
3 about market trends and emerging or nascent technologies, but consistently fail to
4 provide the market-specific data needed by the Commission in order to conduct a
5 meaningful evaluation of the merger.
6
7 **Q. CAN YOU PROVIDE EXAMPLES OF THE TYPES OF ANALYSES THE**
8 **APPLICANTS SHOULD OFFER?**
9
10 A. Yes. With respect to the competition that the merged firms will face from existing
11 commercial wireless services, cable telephony, nascent VoIP technologies and the like,
12 their analysis must evaluate both (1) the application of these technologies to specific
13 markets, including the market for mid-sized business customers who require high
14 capacity DS1-level and above access, and (2) must consider the availability of these
15 alternatives in specific geographic areas. Currently, there is little evidence that these
16 substitutes impose competitive discipline in this particular market.
17
18 **Q. WHO HAS THE BURDEN OF DEMONSTRATING THAT THE LISTED**
19 **TECHNOLOGIES ACTUALLY REPRESENT SUBSTITUTE SERVICES FOR**
20 **CUSTOMERS IN ALL MARKETS?**
21
22 A. The Applicants have this burden. As explained in more detail below, I believe that there
23 are multiple reasons why the alternative technologies listed in the Applicants' testimony
24 do not represent viable substitutes for customer in many markets, including the mid-sized
25 business market that is the focus of my testimony. I provide some of these reasons
26 below. Ultimately, however, it is the Applicants' burden to demonstrate that the

purported substitutes listed in their testimony *do* represent a substitute in a given market, and not the intervener's burden to show that they *do not*.

The Intermodal and Emerging Technologies Identified by the Applicants Do Not Represent Viable Substitutes

Q. DR. TAYLOR ASSERTS THAT FUTURE CHANGES IN TECHNOLOGY ARE NOT ONLY POSSIBLE, BUT HAVE ALREADY OCCURRED. DO YOU AGREE WITH HIS CONCLUSIONS?

A. No. Dr. Taylor begins with a relatively non-controversial (and consequently very broad) observation about the industry, and proceeds – with no intervening market-specific analysis – to reach very specific conclusions. He states that "convergence has transformed the communications market well beyond the traditional wireline arena." A fine observation, to be sure, but in order to determine the impact of the proposed merger in specific markets in Washington, it is essential to address – and not to simply gloss over, as the Applicants have done – questions regarding just how much of a change there has been in specific markets.

Q. HAVE THE MARKETS FOR HIGH-CAPACITY SERVICES PROVIDED TO MID-SIZED BUSINESS CUSTOMERS UNDERGONE ANY RECENT DEVELOPMENT OR CHANGE?

A. No. These services, both on a wholesale and retail basis, are being provided using the same basic technologies, (dedicated circuits over either copper wire or fiber optic facilities) and, in many cases, the same physical facilities that have been in use for years (or decades). While the 1996 Act helped to open these markets to competitive entry, entry by facilities-based carriers has been limited to only a subset of potential locations.

1 As described in more detail in the next section of my testimony, none of the intermodal
2 alternatives or nascent technologies listed by Dr. Taylor represent a viable substitute for
3 these services in the foreseeable future. In reality, the only major change on the horizon
4 for these markets is the possible elimination of the two largest non-ILEC suppliers of
5 both wholesale and retail services.
6
7 **Q. DR. TAYLOR ARGUES THAT LONG TERM PROJECTIONS OF CHANGES IN**
8 **TECHNOLOGY MUST BE REFLECTED IN AN ANALYSIS OF THE IMPACTS**
9 **OF THE PROPOSED MERGER. DO YOU AGREE?**
10
11 A. No. He suggests the Commission to ignore conditions as they exist currently or as they
12 can reasonably be expected to exist when the merger is completed, and instead speculate
13 on potential future changes. Any such attempt to forecast changes is both unnecessarily
14 speculative and inconsistent with the Merger Guidelines.
15 The Merger Guidelines permit the consideration of "*reasonably predictable*
16 *effects of recent or ongoing changes* in market conditions in interpreting market
17 concentration and market share data" (emphasis added, §1.521) The Guidelines also
18 provide an example of that consideration: "if a new technology that is important to long-
19 term competitive viability is available to other firms in the market, but is not available to
20 a particular firm, the Agency may conclude that the historical market share of that firm
21 overstates its future competitive significance."
22 A second factor included in the Guidelines contemplates a situation in which
23 existing market shares increase, rather than decrease, in significance: the magnitude of
24 potential harm from a merger is greater "when demand substitutes outside the relevant
25 market, as a group, are not close substitutes for the products and locations within the

relevant market. There thus may be a wide gap in the chain of demand substitutes at the edge of the product and geographic market." This is the factual condition of many Washington markets today, including the markets for services provided to mid-sized business customers.

Throughout his testimony, Dr. Taylor lists various intermodal alternatives that *may* exist for *some* product markets in *some* geographic markets, but fails to demonstrate that these intermodal alternatives represent a viable substitute for the wireline high-capacity services currently being purchased by mid-sized business customers. The various alternatives that he lists do not represent a substitute that can discipline prices in these markets.

Q. HOW SHOULD DR. TAYLOR HAVE CONSIDERED POTENTIAL SUBSTITUTE PRODUCTS?

A. In order for a purported "intermodal alternative" to represent a viable substitute that can constrain prices, it *must*: (1) include capabilities sufficient to permit the customer's needs to be met, (2) be available at the customer's location, and (3) not rely on the existing wireline facilities (or their equivalent) currently being utilized by the customer.[30]

---

[30] For example, an application that permits the routing of calls or the processing of information to be done in a different way than is currently being done on a circuit-switched network, but that still requires the same underlying local loop facility that the customer is currently using, cannot represent a substitute for that local loop.

1 **Q. DO THE MERGER GUIDELINES PERMIT "POTENTIAL ENTRY" TO BE**
2 **CONSIDERED?**
3
4 A. Yes, but only under specific circumstances not addressed by Dr. Taylor. Simply stating
5 that "potential entry" should be considered is not quite the whole story. The Guidelines
6 consider two scenarios: potential entry of an "uncommitted entrant" (that is, one that
7 successfully enters the market in question *without* expenditure of significant sunk costs of
8 entry and exit), and potential entry of a "committed entrant" (that is one that can
9 successfully enter the market only *with* the expenditure of significant sunk costs of entry
10 and exit).

11 §1.32 of the Merger Guidelines does recognize the possibility that an
12 "uncommitted entrant" might exist and that such a firm could be treated as participating
13 in the relevant market (even if it is not currently doing so) if "their inclusion would more
14 accurately reflect probable supply responses." But the Guidelines make it clear that this
15 is a possibility that exists *only* under a defined set of conditions. Specifically, a firm is
16 treated as an uncommitted entrant and as participating in the market in question *if, but*
17 *only if,* the firm's supply response is "likely to occur within one year *and* without the
18 expenditure of significant sunk costs of entry and exit," and is likely to occur "in
19 response to a 'small but significant and nontransitory' price increase." The Guidelines
20 also provide for a further exclusion: "if a firm has the technological capability to achieve
21 such an uncommitted supply response, but likely would not" because such a response
22 would not be profitable, "that firm will not be considered to be a market participant."

23 §§3.0 – 3.4 recognize the possibility that a "committed entrant" may exist and
24 may properly be treated as participating in the relevant market, but again only under

1 specific conditions: entry into the market must be "so easy that market participants, after
2 the merger, either collectively or unilaterally could not profitably maintain a price
3 increase above premerger levels." Entry is considered to be this easy only if the "entry
4 would be timely, likely, and sufficient in magnitude, character, and scope to deter or
5 counteract the competitive effects of concern." In order to determine whether committed
6 entry is sufficient to "deter or counteract the competitive effects of concern," Merger
7 Guidelines require the use of a three step process: "the first step assesses whether entry
8 can achieve significant market impact within a timely period…the second step assesses
9 whether committed entry would be profitable and, hence, a likely response to a merger
10 having competitive effects of concern…the third step assesses whether timely and likely
11 entry would be sufficient to return prices to their premerger levels."
12

13 **Q. HOW DOES ALL THIS APPLY TO THE MARKETS FOR HIGH-CAPACITY**
14 **SERVICES PROVIDED TO MID-SIZED BUSINESS CUSTOMERS?**
15
16 A. When considering the various alternative and nascent technologies listed by Dr. Taylor, I
17 have applied a multi-part test presented in an Areeda-Hovencamp publication that Dr.
18 Taylor has referred to in other proceedings as "the leading antitrust treatise."[31] The test
19 suggested by Areeda-Hovencamp[32] is both compatible with the Merger Guidelines and
20 useful in considering the potential impact of substitutes., In order for the products to be
21 considered part of the same geographic market, an affirmative response to each question

[31] See Rebuttal Testimony of Dr. William E. Taylor before the Pennsylvania Public Utility Commission, Docket Nos. A-310580F9, A-310401F6, A-310407F3, A-312025F5, A-310752F6, A-310364F3 August 12, 2005, p. 8.

[32] P. Areeda et al., IIA *Antitrust Law* ¶562a at pp. 303-305

1 is required for each geographic location being considered (though a response to only 2a

2 or 2b is necessary).

3 1. Are customers willing to switch in response to relative price changes such that the
4 services have the actual or potential ability to take significant amounts of business
5 away from each other?
6
7 2a. If they are to be considered, are potential suppliers (those not currently participating
8 in the market) who are "uncommitted entrants" likely to begin to supply the market
9 within one year, do so without the expenditure of significant sunk costs of entry and
10 exit, do so in response to a 'small but significant and nontransitory' price increase,
11 and do so profitably?
12
13 2b. If they are to be considered, are potential suppliers (those not currently participating
14 in the market) who are "committed entrants" able to achieve significant market
15 impact within a timely period, do so profitably, and would such timely and likely
16 entry be sufficient to return prices to their premerger levels?
17
18 3. Can a high correlation be shown to exist in the prices or price movement of the two
19 products?
20

21 I will apply these three elements to the various intermodal alternatives that Dr. Taylor

22 lists in his testimony.

23

24 *VoIP Does Not Represent a Viable Substitute*

25 **Q. WHY ARE VoIP SERVICES NOT A SUBSTITUTE FOR THE SERVICES**
26 **REQUIRED BY MID-SIZE BUSINESS CUSTOMERS?**
27
28 A. In reality, VoIP is not a separate, independent service alternative at all. Instead, it is a

29 switching application that can be provided only over a broadband connection to the

30 customer's premises. Dr. Taylor seems to understand this fact even though he fails to

31 take it account in his analysis: "(1) cable companies use VoIP technology over their own

32 networks to provide "cable telephony" without requiring customers to subscribe to

33 broadband service; (2) VoIP service can be provided as a software application over

1 customers' existing broadband (DSL or cable) connections and uses the public Internet to
2 transport calls; and (3) businesses use VoIP equipment on their private networks and
3 switching systems in place of traditional telephone services." (p. 31) VoIP providers do
4 not own this essential facility, but must acquire it (or the end user customer must acquire
5 it) from an existing provider.[33] VoIP thus is not distinct from cable telephony or service
6 from another facilities-based provider but is simply a technology that permits a
7 broadband connection to be used to provide voice service. If a CLEC, for example,
8 wanted to provide VoIP services, it could only do so either by constructing its own
9 broadband facilities to the customer location (if building access and financial issues could
10 be overcome) or far more likely by obtaining those facilities from Verizon.[34] VoIP is not
11 a viable substitute if it can be provisioned only over Verizon facilities.

12 Even with that understanding, the long run growth of VoIP remains at the mercy
13 of a number of future operating cost increases, including a now-estimated but as yet
14 unimplemented obligation to pass E911 calls seamlessly, in both VoIP's fixed and
15 "roaming" modes. Other costs likely to be imposed include those associated with
16 mandated law enforcement assistance, relay services for the hearing impaired and
17 perhaps a variety of state and local taxes.

---

[33] Even Dr. Taylor notes that customers can only order VoIP where "broadband access is available." Taylor Direct, p. 75.

[34] It is my understanding of the Supreme Court's *Brand X* decision that cable operators cannot be required to provide other carriers with access to their networks, and there is little reason to believe that they would willingly provide such access to another facilities-based provider.

1 The recent U.S. Supreme Court ruling[35] raised the possibility that new, overt
2 barriers to entry by independent VoIP providers may develop in the future. For
3 example, one analysis of the decision states:

4 In its recent ruling against a small Internet service provider called
5 Brand X Internet, the U.S. Supreme Court said that cable operators
6 don't need to share their broadband access lines with other
7 businesses. That's good news for big cable companies but could be
8 trouble for voice-over-Internet Protocol providers like Vonage,
9 which sell digital phone service. Unregulated cable lines and the
10 possibility of deregulated phone lines could lead to widespread
11 blocking of VoIP traffic by big cable and phone companies looking
12 to protect their turf. "I believe it's a matter of when, not if," says
13 Jeff Pulver, chief executive of VoIP service provider Free World
14 Dialup. "If I'm a service provider offering my own voice-over-
15 broadband offering, and I've got the ability to block my
16 competition, why not?" [36]
17

18 Meaningful analysis of VoIP requires information about the levels of VoIP costs, for
19 example, the initial capital outlays needed to establish VoIP, or whether these costs
20 exhibit economies of scale or scope, and whether or how a particular provider's
21 ownership of actual local or intercity transmission capacity affects the costs of VoIP.
22 Thus, based upon the nascent development of VoIP today and its future cost
23 obligations questions exist about VoIP even in the mass market, much less in the mid-
24 sized business market.

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[35] National Cable & Telecommunications Association v. brand-X Internet Services et al (Case No. 04-277), June 27, 2005.

[36] "More Worries for VoIP Vendors," Forbes.com, June 28, 2005.
www.forbes.com/2005/06/28/voip-cable-bocked-cx_de_0628voip_print.html

Q. IS THERE ANY EVIDENCE THAT MID-SIZED BUSINESS CUSTOMERS ARE WILLING TO SWITCH FROM WIRELINE HIGH-CAPACITY SERVICES TO VoIP SERVICE IN RESPONSE TO RELATIVE PRICE CHANGES SUCH THAT THE SERVICES HAVE THE ACTUAL OR POTENTIAL ABILITY TO TAKE SIGNIFICANT AMOUNTS OF BUSINESS AWAY FROM EACH OTHER?

A. No, because such a substitution is physically impossible. VoIP is a switching protocol that requires the presence of wireline high-capacity facilities with the required bandwidth, and these facilities still must be purchased by either the retail provider or by the end user customer. *The availability of an optional use of the required facility cannot discipline the price for the facility itself*. With or without VoIP, the proposed merger would increase concentration, reduce the availability of wholesale facilities, and increase the prices paid by end users for these services.

Q. IS THERE ANY EVIDENCE THAT POTENTIAL SUPPLIERS OF VoIP SERVICES ARE LIKELY TO BEGIN TO SUPPLY THE MID-SIZED BUSINESS MARKETS WITHIN ONE YEAR, DO SO WITHOUT THE EXPENDITURE OF SIGNIFICANT SUNK COSTS OF ENTRY AND EXIT, DO SO IN RESPONSE TO A 'SMALL BUT SIGNIFICANT AND NONTRANSITORY' PRICE INCREASE, AND DO SO PROFITABLY?

A. No, but the question is moot. No amount of competition for VoIP will impact the markets for the underlying essential facilities.

Q. IS THERE ANY EVIDENCE THAT POTENTIAL SUPPLIERS OF VoIP SERVICES, EVEN THOSE THAT MUST ENTER WITH THE EXPENDITURE OF SIGNIFICANT SUNK COSTS OF ENTRY AND EXIT, ARE LIKELY TO BE ABLE TO ACHIEVE SIGNIFICANT MARKET IMPACT WITHIN A TIMELY PERIOD, DO SO PROFITABLY, AND BE SUFFICIENT TO RETURN PRICES TO THEIR PREMERGER LEVELS?

A. No, but this question is also moot. No amount of competition for VoIP will impact the markets for the underlying essential facilities.

Q. IS THERE ANY EVIDENCE THAT A HIGH CORRELATION EXISTS IN THE PRICES OR PRICE MOVEMENT FOR WIRELINE HIGH-CAPACITY SERVICES AND VoIP SERVICES?

A. No. The prices for VoIP, as an application that requires the use of certain network facilities, have declined somewhat, while the prices for the necessary underlying facilities have increased, but no discernable correlation exists. There is no correlation and no potential substitution.

Wireless Does Not Represent a Viable Substitute

Q. WHY ARE MOBILE WIRELESS SERVICES NOT A SUBSTITUTE FOR THE SERVICES REQUIRED BY MID-SIZE BUSINESS CUSTOMERS?

A. Dr. Taylor spends significant time on the success of the wireless industry (pp. 21-27) but forgoes actually conducting an analysis, in favor of broad claims (p. 26) that "the proliferation of wireless services has expanded substantially in every one of the last 20 years and shows no sign of abating." While this general statement may be true, the growing use of wireless services in the mass markets does not translate into a substitute in the mid-sized business market. A single wireless phone *may* be able to be a substitute for a home telephone line and complement for businesses mobile employees. But 250 individual cell phones are not an effective substitute for a business telephone system serving 250 office employees.

Dr. Danner at page 12 of his testimony mentions the use of a wireless product by Ford, but this product appears to rely on antennas in Ford's buildings, rather than public cell cites, and does not represent a complete actual substitute for high capacity building access links. In fact, the "integrated IP networks" to which he refers are substitutes for

1 in-building communications tools like the traditional PBX, Centrex and LAN data
2 networks. High capacity access to the building itself is still required.
3
4 **Q. DR. TAYLOR ASSERTS (PP. 41-43) THAT FIXED WIRELESS SERVICES (AND**
5 **PARTICULARLY WiMax SERVICE) REPRESENT A SUBSTITUTE FOR THE**
6 **SERVICES REQUIRED BY MID-SIZED BUSINESS CUSTOMERS. IS HE**
7 **RIGHT?**
8
9 A. No. WiMax may, if existing technical and economic viability problems are solved, have
10 the *potential* to provide a substitute for some wireline high-capacity access in the future,
11 but rather than proving to be clear substitute for building access facilities in the market
12 for mid-sized business customers, WiMax illustrates why nascent technologies should be
13 analyzed with extreme care before touting them as competitive substitutes. WiMax is
14 subject to a number of unresolved technical and economic issues.
15 A second constraint, not mentioned by Dr. Taylor, is that in many cases today a
16 customer utilizing WiMax will still require wireline facilities to connect its wireless
17 WiMax facilities to the public switched telephone network. WiMax capabilities, where
18 operational today, appear to be substitutes for in-building communications tools like the
19 traditional PBX, Centrex and LAN data networks, but high-capacity wireline access to
20 the building itself is still required. In these instances, widespread deployment of WiMax
21 may ultimately be expected to increase, rather than decrease, the wireline high-capacity
22 facilities and services that mid-sized business customers will need, and does not change
23 the fact that Verizon will dominate that market within its region.

1 **Q. DOES XO HAVE ANY EXPERIENCE WITH FIXED WIRELESS SERVICES?**
2
3 A. Yes, XO has spent considerable resources in developing fixed wireless technical
4 capabilities, but has no existing service offerings. XO's 2004 10-K refers to "*ongoing*
5 *development* of technical equipment and data encryption and compression protocols that
6 permit the use of high bandwidth wireless connections between physical locations that
7 are located within a line of sight across relatively short distances;" but makes no
8 statement of full deployment or widespread commercial availability.
9 Other recent statements by the company provide an assessment of wireless
10 mobile's current viability: "XO's experience is that wireless loop technology suffers from
11 technical frailties and economic problems that preclude its use as a substitute for wireline
12 UNE loops for the vast majority of our business customers…XO previously tried to
13 deploy equipment in approximately 30 markets that would enable us to use our LMSC
14 spectrum to self-provision wireless local loops between our network and customer
15 buildings. Despite our best efforts, the roll-out was a failure. We deployed and tested
16 equipment from four leading manufacturers and none of it performed at a level required
17 for commercial acceptance"[37] XO's Director of Transport Architecture went on to state
18 that while the company expects to be able to make use of this investment "at some
19 indeterminate future point," he concludes that "it is very clear that widespread
20 commercial deployment of wireless local loops will not occur in the near future."[38]

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[37] Declaration of Wil Tirado on behalf of XO Communications, Inc., WC Docket No. 04-313 and CC Docket No. 01-338, October 1, 2004, ¶¶22-24.

[38] Id., ¶25.

1 Technological constraints also affect the potential use of fixed wireless services.
2 The systems operate only on a line-of-sight basis, are viable only for short distances, and
3 are hampered by limitations regarding antenna placement.[39]
4
5 **Q. IS THERE ANY EVIDENCE THAT MID-SIZED BUSINESS CUSTOMERS ARE**
6 **WILLING TO SWITCH FROM WIRELINE HIGH-CAPACITY SERVICES TO**
7 **FIXED WIRELESS SERVICES IN RESPONSE TO RELATIVE PRICE**
8 **CHANGES SUCH THAT THE SERVICES HAVE THE ACTUAL OR**
9 **POTENTIAL ABILITY TO TAKE SIGNIFICANT AMOUNTS OF BUSINESS**
10 **AWAY FROM EACH OTHER?**
11
12 A. No. The failure of even the test facilities to "perform at a level required for commercial
13 acceptance" underscores the fact that customers have neither the opportunity nor the
14 willingness to make such a substitution today.
15
16 **Q. IS THERE ANY EVIDENCE THAT POTENTIAL SUPPLIERS OF FIXED**
17 **WIRELESS SERVICES ARE LIKELY TO BEGIN TO SUPPLY THE MID-SIZED**
18 **BUSINESS MARKETS WITHIN ONE YEAR, DO SO WITHOUT THE**
19 **EXPENDITURE OF SIGNIFICANT SUNK COSTS OF ENTRY AND EXIT, DO**
20 **SO IN RESPONSE TO A 'SMALL BUT SIGNIFICANT AND**
21 **NONTRANSITORY' PRICE INCREASE, AND DO SO PROFITABLY?**
22
23 A. No. XO has invested approximately one billion dollars in the deployment of the
24 technology to date, and while it has hopes of utilizing this technology for commercial
25 application in the future, it cannot currently do so. This investment represents substantial
26 sunk costs, so entry by an "uncommitted entrant" is not possible. No change in the price
27 for wireline high-capacity service will cause mid-sized business customers to substitute

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[39] Id., ¶27-28.

1 fixed wireless services, because the service is not commercially available. Even with
2 commercial viability, there is no reason at this time to expect profitability.
3
4 **Q. IS THERE ANY EVIDENCE THAT POTENTIAL SUPPLIERS OF FIXED**
5 **WIRELESS SERVICES, EVEN THOSE THAT MUST ENTER WITH THE**
6 **EXPENDITURE OF SIGNIFICANT SUNK COSTS OF ENTRY AND EXIT, ARE**
7 **LIKELY TO BE ABLE TO ACHIEVE SIGNIFICANT MARKET IMPACT**
8 **WITHIN A TIMELY PERIOD, DO SO PROFITABLY, AND BE SUFFICIENT**
9 **TO RETURN PRICES TO THEIR PREMERGER LEVELS?**
10
11 A. No. Even after significant capital investment WiMax entry is not expected to be
12 profitable until the 2007/2008 timeframe, and even then such profitability is questionable.
13 Existing and anticipated WiMax penetration has not eroded existing margins for special
14 access (and is not expected to do for at least another year and not significantly until
15 2008). As s a result, WiMax cannot be relied upon to "return prices to their premerger
16 levels" within a "timely period."
17 The inescapable fact remains, that after any meaningful application of the Merger
18 Guidelines, one must conclude that fixed wireless services, including WiMax, do not
19 represent a substitute that can discipline prices for wireline high-capacity services
20 provided to mid-sized business customers.
21
22 **Q. IS THERE ANY EVIDENCE THAT A HIGH CORRELATION EXISTS IN THE**
23 **PRICES OR PRICE MOVEMENT FOR WIRELINE HIGH-CAPACITY**
24 **SERVICES AND FIXED WIRELESS SERVICES?**
25
26 A. No. Such an analysis is premature since market prices for fixed wireless services have
27 yet to be established (and even the preliminary prices that do exist are not at profitable
28 levels) and require, at a minimum, that commercial viability first be established. It is

1 clearly premature to conclude that because of the presence of fixed wireless options, the
2 proposed merger will not "create or enhance market power" or to "facilitate its exercise."

3 *Cable Telephony Services Do Not Represent a Viable Substitute*

4 **Q. WHY ARE INTERMODAL OPTIONS, SUCH AS CABLE TELEPHONY, NOT A**
5 **SUBSTITUTE FOR THE SERVICES REQUIRED BY MID-SIZE BUSINESS**
6 **CUSTOMERS?**
7
8 A. Dr. Taylor discusses recent network investments by cable companies,[40] but completely
9 fails to deal with two major issues: (1) the fact that cable cannot serve the market in
10 question and (2) the serious technical limitations of a cable network.

11 Some analyses of intermodal competition discuss cable's marketing efforts in the
12 business market, but available data indicate that to the extent cable companies target
13 business customers at all, their efforts are targeted towards the smaller, mass market end
14 of the small business markets. It's not clear how - or even if - cable is targeting mid-
15 sized businesses that have offices in multiple cable franchise areas. Nor is there evidence
16 that cable can provide (in both a technological and a commercial sense) the bandwidth or
17 the reliability that a business currently relying on multiple DS1 loops would need. While
18 a great deal of bandwidth can be derived from coaxial cable facilities, many applications
19 including "on-demand" and high definition video services compete with telephony for
20 this capacity and are likely to be more profitable to the cable operators, suggesting that it
21 is unlikely that these companies would expend the significant resources to build into and

[40] Taylor Direct, p. 19-21

gain threshold market share.[41]

In the end, possible fringe market entry by intermodal alternatives are not economic substitutes for the facilities and services that mid-sized business customers in Washington need and will continue to need through the foreseeable future. Their presence cannot offset the likelihood of adverse price and structural effects from the merger. Fringe competition, particularly by providers using nascent technologies, may actually be an indicator that such providers are subject to economic barriers to market entry or expansion (or it may simply indicate that the nascent technology needs further development before widespread commercial deployment can be viable). If market entry occurs only at the fringe, its existence is not sufficient to eliminate the need for empirical examination; a market analysis cannot simply blend these technologies into a category labeled "things other than Verizon's traditional services" and then claim them to be viable substitutes in all markets.

Q. IS THERE ANY EVIDENCE THAT MID-SIZED BUSINESS CUSTOMERS ARE WILLING TO SWITCH FROM WIRELINE HIGH-CAPACITY SERVICES TO CABLE SERVICES IN RESPONSE TO RELATIVE PRICE CHANGES SUCH THAT THE SERVICES HAVE THE ACTUAL OR POTENTIAL ABILITY TO TAKE SIGNIFICANT AMOUNTS OF BUSINESS AWAY FROM EACH OTHER?

A. No. In most cases, these necessary facilities are not available at mid-sized business locations. Even where the services are available, technical constraints limit their viability to substitute for the wireline facilities provided by Verizon and a pre-merger MCI.

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[41] Dr. Taylor discusses (pp.66-69) the widespread use of cable modems throughout Washington, but does not explain how the more limited bandwidth of cable services can serve as a substitute for facilities that mid-sized business customers require.

1 **Q. IS THERE ANY EVIDENCE THAT POTENTIAL SUPPLIERS OF CABLE**
2 **SERVICES ARE LIKELY TO BEGIN TO SUPPLY THE MID-SIZED BUSINESS**
3 **MARKETS WITHIN ONE YEAR, DO SO WITHOUT THE EXPENDITURE OF**
4 **SIGNIFICANT SUNK COSTS OF ENTRY AND EXIT, DO SO IN RESPONSE TO**
5 **A 'SMALL BUT SIGNIFICANT AND NONTRANSITORY' PRICE INCREASE,**
6 **AND DO SO PROFITABLY?**
7
8 A. No. The geographic expansion of the necessary facilities would entail significant sunk
9 costs and an extended deployment schedule. There is no evidence that the significant
10 price increase in Verizon's special access services have caused cable companies to
11 deploy facilities in order to provide services to mid-sized business customers, nor is there
12 any evidence that cable companies believe they could profitably do so.
13
14 **Q. IS THERE ANY EVIDENCE THAT POTENTIAL SUPPLIERS OF CABLE**
15 **SERVICES, EVEN THOSE THAT MUST ENTER WITH THE EXPENDITURE**
16 **OF SIGNIFICANT SUNK COSTS OF ENTRY AND EXIT, ARE LIKELY TO BE**
17 **ABLE TO ACHIEVE SIGNIFICANT MARKET IMPACT WITHIN A TIMELY**
18 **PERIOD, DO SO PROFITABLY, AND BE SUFFICIENT TO RETURN PRICES**
19 **TO THEIR PREMERGER LEVELS?**
20
21 A. No. There is no evidence that cable companies could profitably extend their facilities to
22 business locations, they could do so within a timely period, or could achieve a level of
23 market penetration that would be sufficient to return prices to their premerger levels.
24
25 **Q. IS THERE ANY EVIDENCE THAT A HIGH CORRELATION EXISTS IN THE**
26 **PRICES OR PRICE MOVEMENT FOR CABLE-PROVIDED SERVICES AND**
27 **HIGH-CAPACITY WIRELINE SERVICES?**
28
29 A. No. Once again, the limited availability of the necessary facilities at the locations where
30 they would be needed limits potential substitution. Dr. Taylor presents no evidence that
31 any correlation in prices exists for these services, even in those locations – if any - where
32 the facilities are available.

1 **Q. PLEASE SUMMARIZE THE APPLICANTS' COMPETITIVE ANALYSIS.**
2
3 A. Ultimately, there is very little to the analysis, particularly with respect to the threshold
4 issue of market definition. It is essential for the Applicants to provide a coherent
5 definition of the specific markets they are analyzing; otherwise it is impossible to gauge
6 the competitive impacts – if any exist - of various forms of intermodal competition
7 including cable telephony, mobile wireless, WiMax, and VoIP. A relevant analysis must
8 demonstrate which intermodal technologies would be able to operate in particular
9 markets as effective substitutes for MCI's services. The market for high-capacity
10 building access used by mid-sized business customers is clearly limited in its capacity to
11 use these substitutes and thus ILECs like Verizon and CLECs like XO and Covad will
12 remain the principal direct competitors in the market. This Commission should ensure
13 that the proposed merger does not affect this direct competition by adopting the important
14 conditions that I outline later in my testimony.
15

16 **The Commission Should Consider the Impact of the Merger on the market for High-**
17 **Capacity Building Access Provided to Mid-Sized Business Customers**
18

19 *High-Capacity Building Access Is Integral to a Competitive Market for Services Provided*
20 *to Mid-Sized Business Customers*

21 **Q. CAN YOU EXPLAIN WHY THE MARKET FOR HIGH-CAPACITY LOOP AND**
22 **TRANSPORT FACILITIES (E.G. BUILDING ACCESS) PROVIDED TO MID-**
23 **SIZED BUSINESS CUSTOMERS IS IMPORTANT?**
24
25 A. Yes. The Commission has an obligation to insure that *all* ratepayers, including but not
26 limited to mid-sized business customers, receive telephone service at rates that are fair,
27 just, and reasonable. More fundamentally, telecommunications is a critical component of
28 the operations of nearly all businesses. If Washington customers face a reduction in

1 competitive choice and an increase in the prices, they pay for telecommunications
2 services, they will suffer economically and the state economy will suffer with them. In
3 order to sustain competition in the market for mid-sized business customers, it is essential
4 that the remaining independent CLECs have reliable access to the necessary local loop
5 and transport facilities at reasonable rates and under reliable conditions.

6 Access to customer premises is the key asset that CLECs have not replicated and
7 will not be able to replicate in the near future. Entry into this market is characterized by
8 high sunk costs, long lead times and significant capital commitments – all of which were
9 of limited or no concern to the ILECs who constructed these facilities as the only
10 provider in the market. Even with clear governmental policy goals of fostering
11 competition, the market is characterized by a number of serious challenges: (1) extreme
12 regulatory uncertainty about continued access to unbundled facilities, (2) price levels for
13 ILECs' special access services that are exorbitant and likely reflect monopoly profits, and
14 (3) a limited market for wholesale alternatives to the ILECs' services. This last point is
15 directly affected by the proposed Verizon-MCI merger (and is significantly exacerbated
16 by the proposed combination of SBC and AT&T).
17
18 **Q. DOES YOUR MARKET DEFINITION INCLUDE SERVICES PROVISIONED**
19 **VIA BOTH UNES AND SPECIAL ACCESS?**
20
21 A. Yes. For purposes of understanding the longer term effects of the proposed merger,
22 including an analysis of the adverse competitive impacts in the competitive wholesale
23 market for high capacity building access, neither the *current* status of special access nor

1 Section 251 UNEs has any relevance. A proper inquiry concerns the longer-term, "non-
2 transitory" effects of the merger.

3 With respect to special access services, the current jurisdictional framework of
4 regulation is not a consideration. The Commission should consider all rate and price
5 effects when evaluating whether the proposed merger is in the public interest, and should
6 consider those effects on the customers who ultimately would pay for any significant,
7 non-transitory price increases. If prices of telecommunications services will increase,[42]
8 Washington customers - in this case businesses that use services provided by the newly-
9 merged Verizon/MCI or one of the smaller competitors like XO or Covad - will face
10 higher operating costs. Even if those higher costs are caused by a national merger, the
11 impact still will be borne by consumers who are *in* Washington, which is why the
12 Commission should consider *all* possible adverse competitive consequences.

13 Independent of the Commission's duty to protect all ratepayers, the adverse
14 competitive impacts of a Verizon-MCI combination are not related to any special access
15 rates that are now or may in the future be authorized by FCC policies. Even if the FCC
16 were to place a freeze on Verizon's special access tariffs tomorrow, the adverse
17 competitive effects would still occur, because special access rates are not competitively
18 established and, based on current returns, are higher than the level that could be sustained
19 in an effectively competitive market. The adverse effects of the merger will result from

[42] It is important to remember that a failure to lower excessive prices is the equivalent of a price increase. Indeed, the FCC made clear several years ago that special access prices were excessive, but that it was counting on competition to drive those rates down. If a consequence of this merger is that special access rates will never be lowered because of the loss of MCI as a direct retail competitor and wholesale supplier to other retail competitors, that is, for economic analysis purposes, the same thing as a price increase.

1 the withdrawal of MCI as a viable retail and wholesale competitor to Verizon (and would
2 be compounded by the simultaneous withdrawal of AT&T - the other large supplier of
3 competitive wholesale access - from the wholesale market). End users will no longer be
4 able to pick the previous lowest price from any supplier because all CLECs' costs will
5 increase. The result will be higher consumer prices and perpetual reliance on Verizon's
6 special access facilities.[43] By removing competitive pressure on Verizon to reduce its
7 special access rates, and by denying customers the opportunity to purchase comparable
8 facilities from other carriers at rates that are below existing special access, the proposed
9 merger itself creates the adverse increases in the costs of access to mid-sized customers'
10 premises.[44]

---

[43] Dr. Danner (p. 22) suggests that no rate changes will result from the proposed merger.

[44] The FCC's current regulatory posture with respect to special access services is an example of two concurrent failures: a market failure (lack of special access competition) and a government policy failure (the FCC's multi-year delay in even beginning to investigate special access pricing in a proceeding in which opening comments were just received), evidenced by unrefuted, empirical economic evidence that the FCC's 1999 "pricing flexibility" rate deregulation have been ineffective. Many stakeholders, large businesses, governments, commercial wireless telecommunications providers and competitive telephone companies (including, until recently, AT&T and MCI) have commented on conditions with respect to special access.

1 *An Evaluation of the Proposed Merger Should Not Be Based on an Assumption that*
2 *Section 251 UNEs Will Continue to be Available*

3 **Q. UNDER THE FCC'S *TRRO*[45] ARE SECTION 251 UNES PROVIDED BY**
4 **VERIZON TREATED AS SUBSTITUTES FOR ANY COMPETITIVE**
5 **WHOLESALE ALTERNATIVES TO VERIZON'S SPECIAL ACCESS**
6 **SERVICES?**
7
8 A. No. Recall that the relevant test is whether a market substitute that could ameliorate the
9 adverse competitive effects of a merger will be sustainable in the long run. No analysis
10 of the FCC's TRRO could reasonably conclude that the continued existence of loop and
11 transport UNEs under Section 251 is guaranteed or even likely. For this reason, rates
12 overseen by the Commission for UNEs required under Section 271 of the
13 Telecommunications Act must be offered as an alternative to Verizon's special access
14 services.
15

16 **Q. WHY ARE SECTION 251 UNES AN INADEQUATE SUBSTITUTE?**
17
18 A. Because it is highly likely that at some point in the future – before intermodal alternatives
19 or emerging technologies represent viable substitutes, section 251 UNEs will no longer
20 be available. It is significant that both SBC and Verizon are challenging the FCC's
21 recent TRRO impairment rules on appeal to the D.C. Circuit, and are essentially asking
22 the Court to jettison all of the remaining rules requiring ILECs to provide high capacity
23 loops and transport as Section 251 UNEs. Even assuming that the RBOC effort to kill
24 the UNE rules fails, the TRRO impairment rules effectively eradicate a substantial

---

[45] In the Matter of Unbundled Access to Network Elements; Review of the Section 251, Unbundling Obligations of Incumbent Local Exchange Carriers, Order on Remand, WC Docket No. 04-313, CC Docket No. 01-338, FCC 04-290 (Feb. 4, 2005) ("TRRO" or "Order"), appeals pending sub nom. Covad v. FCC, No. 05-1095 and cons. cases (D.C. Cir.).

1 proportion of loop and transport UNEs within a year. Therefore, XO and Covad's
2 proposed pricing reforms for network elements represent the bare minimum steps that the
3 Commission should undertake in order to protect independent CLECs and ultimately to
4 protect end users.
5
6 **Q. CAN YOU SUMMARIZE THE FCC'S FORMULATION IN THE *TRRO***
7 **REGARDING UNE IMPAIRMENT?**
8
9 A. Yes. The modified tests adopted by the FCC in the TRRO for the continued availability
10 of loop and transport UNEs under Section 251 rely principally on threshold number of
11 "fiber-based collocators" and the line size of the wire centers where CLECs either
12 continue to be, or are no longer impaired. The wire center line sizes are an alternative
13 measure of "non-impairment" in the case of dedicated transport, and both the requisite
14 number of "fiber-based collocators" and the wire center line size metric must be satisfied
15 for high capacity DS1 and DS3 loops to be deemed "non-impaired."
16 A finding of continued impairment for unbundled loops under Section 251 is the
17 condition that must persist for a "significant, non transitory period of time" for purposes
18 of merger analysis. Apart from the question of whether the new rules will survive the
19 RBOCs challenge on appeal, there are problems with the FCC formulation; even under
20 the revised rules of the TRRO, the continued existence of high capacity loop UNEs and
21 transport UNEs under Section 251 (absent the adoption of XO/Covad's proposed
22 remedies) is likely to be, at best, a highly transitory condition.

1 **Q. WHY ARE THE *TRRO* RULES UNLIKELY TO MAKE UNES A SUSTAINABLE,**
2 **LONG TERM SUBSTITUTE FOR VIABLE WHOLESALE BUILDING ACCESS**
3 **FACILITIES?**
4
5 A. There are several reasons. First, the Commission should recognize that, at the end of the
6 day, the purpose of the new TRRO impairment rules was to eliminate high capacity
7 UNEs in many places. The new rules established a two-part "bright line" test for both
8 high capacity loops and transport. Section 251 UNEs are simply eliminated in areas
9 where (1) a specified threshold number of fiber based collocators exist and/or (2) the wire
10 center serves a specified density of lines.[46] The FCC's rationale for the rules is that the
11 existence of a sufficient number of fiber based collocators provides a reasonable
12 presumption that competitive entry is economic and that enough competitors have
13 deployed facilities to provide alternative facilities choices for both end users and carriers.
14 Relying largely on the fact that AT&T and MCI are fiber based collocators in
15 many wire centers, SBC, Verizon, and other ILECs notified the FCC over the past few
16 months of their intent to eliminate Section 251 UNEs on many routes. Although a
17 relatively small absolute number of wire centers are affected, the wire centers that are
18 deemed "non-impaired" are those that serve by far the largest number of customers and

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[46] The rules require minimum wire center line sizes; 60,000 business lines is the threshold for finding non-impairment with respect to DS1 loops or special access facilities, for example. The line is drawn at wire centers with 38,000 or more business lines for DS3 UNE loop impairment. Any empirical modeling of the complex factors that govern the construction of telecommunications facilities would have to consider many other factors and might produce a very different breakpoint than the FCC selected in the *TRRO*.

1 handle the largest proportion of traffic. Accordingly, CLECs will soon lose access to
2 many of the Section 251 UNEs upon which they rely today. [47]
3 Second, the phase-out of Section 251 UNEs under the TRRO is worsened by the
4 operation of the "one-way ratcheting" affect of the rules. Under the terms of the new
5 impairment rules, once it is determined that the threshold number of fiber-based
6 collocators exists and a route or wire center is deemed “non-impaired,” there is no re-
7 counting and re-listing if the number of fiber-based collocators present later falls below
8 the threshold level.[48] In preparing the initial lists of wire centers where the three and
9 four fiber-based collocator tests were satisfied, SBC and Verizon undoubtedly treated
10 AT&T and MCI as qualified fiber-based collocators and relied upon their presence to
11 meet the Section 251 “non-impairment” test on most routes where UNEs are being
12 eliminated. The ink was not even dry on the TRRO before Verizon and SBC effectively
13 pulled a "bait and switch" by first counting AT&T/MCI as competitors and then
14 immediately withdrawing them as competitors in the market. Therefore, even the non-
15 impairment showings already made under the TRRO are largely based on a phantom
16 competitive presence.

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[47] Section 271 UNEs represent an obligation that is distinct from, and independent of, the Section 251 “impairment” criteria, and are a key requirement for allowing local telecommunications competition in Washington to continue to exist. The need for the Commission to ensure that these alternatives exist and are priced appropriately, is all the more acute because of the significant probability that widespread new competition among ILECs (Verizon competing with SBC and vice versa) will not develop (for the rational economic reasons explained later in my testimony).

[48] For example, the *TRRO* rules state, “Once a wire center exceeds both of these thresholds, no future [DS1 or DS3] loop unbundling will be required in that wire center.” Section 51.319 (a) (4) and (5).

1 **Q. ARE THERE ANY OTHER PROBLEMS WITH THE *TRRO* FORMULATION**
2 **FROM A PRACTICAL STANDPOINT?**
3
4 A. Yes. The use of fiber based collocators is a slight variation on the test the FCC adopted
5 to largely deregulate rates for special access services in 1999. However, many parties,
6 including AT&T itself, subsequently argued that the use of fiber based collocators to
7 "measure the extent to which competitors have made sunk investments in facilities used
8 to compete with incumbent LEC' was erroneous."[49] As applied to dedicated transport,
9 AT&T said the number of fiber-based collocators "is inherently flawed, because it
10 focuses only on whether there are some fiber deployed in a collocation, not whether the
11 CLEC's facilities fully bypass the Bell's transport facilities….The [fiber based
12 collocator] triggers for [loops] are even less representative of the existence of relevant
13 sunk investment, because they rely exclusively on a showing of transport deployment as
14 evidence of loop deployment." Loop rates ("channel terminations") can be deregulated
15 under the FCC rules, AT&T noted, "without showing that CLECs have deployed a single
16 loop anywhere in the MSA."[50]

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[49] AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, RM-10593, filed Oct. 15, 2002 ("AT&T Special Access Rate Petition"), pp. 20-21.

[50] AT&T Special Access Rate Petition, pp. 1, 4. *Emphasis added*.

1 **Q. CAN THE PROVISION OF SECTION 251 UNES BY VERIZON UNDER**
2 **CURRENT AND EXPECTED FUTURE CONDITIONS MITIGATE THE**
3 **COMPETITIVE EFFECTS CAUSED BY MCI'S REMOVAL FROM THE**
4 **WHOLESALE MARKET?**
5
6 A. No. The non-transitory time frame needed to offset the adverse price and competition
7 effects of the proposed merger – especially given the costs and lead times needed to build
8 telecommunications facilities will be short-circuited by the vulnerability of the FCC's
9 new UNE "impairment" rules to further judicial foreclosure, and the FCC's choice of a
10 "non-impairment" metric (the existence of "fiber-based collocators") that does not relate
11 to *any* actual facilities-based competition. This effectively means that Section 251 UNEs
12 provided under current conditions *do not count* for purposes of a merger analysis.
13 The potential of the Verizon-MCI merger to increase prices for customers of
14 Verizon, for customers of the pre-merger MCI, and for CLECs, is not affected in any way
15 by the current existence of UNEs or any FCC rules regarding Verizon's pricing of special
16 access services. The Commission should require Verizon to adopt XO and Covad's
17 proposed reforms for network elements.
18
19 **Q. HAVE OTHER STATES CONSIDERED THE IMPACT OF THE PROPOSED**
20 **MERGERS ON BOTH WHOLESALE AND RETAIL SERVICES?**
21
22 A. Yes. The New York PSC Staff, for example, addresses this issue in the attached White
23 Paper. The New York Staff explicitly defined a relevant market (or, more accurately, a
24 set of geographic markets), identified the market participants, and analyzed the impact of
25 the proposed merger on market concentration for *wholesale* transport services. Based on
26 the data they collected and reviewed, The New York Staff concluded that "the proposed
27 merger substantially reduces the number of competitive transport routes. Further, the

1 impact of the merger on competition is significant even for many of the routes considered
2 to be the most competitive under the TRRO procedures."[51] The New York Staff then
3 followed the same analytical framework[52] for "Special Access and High Capacity Loops
4 (Retail and Wholesale)," and went on to reach tentative conclusions that the proposed
5 merger will "significantly increase market concentration in the transport and special
6 access markets," including wholesale services, and summed up by stating "the current
7 field of *wholesale service providers* will be reduced by one major provider, and because
8 AT&T is being acquired by another former RBOC, the potential for price or rate
9 collusion, or discrimination in the provision of access for transport or special access
10 facilities in favor of their respective affiliates, increases (*to the detriment of small*
11 *carriers and business customers*)."[53]

12 In its comments in response to the White Paper, the Office of the New York
13 Attorney General reached similar conclusions. The Attorney General describes MCI and
14 AT&T as "crucial sources of wholesale special access services resold to other smaller
15 scale competitors," and concludes that "MCI's merger with Verizon would also mean
16 that other CLECs would lose MCI's wholesale special access offering. As enterprise
17 customers lose alternative suppliers, Verizon would be able to increase rates without
18 meaningful challenge."[54]

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[51] New York PSC Staff White Paper, pp. 33-37.
[52] Id., pp. 38-46.
[53] Id., p. 44 (emphasis added).
[54] Comments of the State of New York Office of Attorney General in PSC Case Nos. 05-C-0237 and 05-C-0242, pp. 2, 5-6.

Q. IS THE NEW YORK PSC STAFF THE ONLY REGULATORY STAFF TO CONDUCT AN INVESTIGATION OF THE PROPOSED MERGERS ON BOTH WHOLESALE AND RETAIL HIGH-CAPACITY SERVICES PROVIDED TO BUSINESS CUSTOMERS?

A. No. More recently, the Staff of the Virginia State Corporation Commission conducted a similar analysis, and also specifically focused on the potential impact on high-capacity loop and transport services that are provided on a wholesale basis. The Virginia Staff concluded that "to the extent the merger removes MCI as an alternative potential dedicated transport provider, this could have consequences on competitors and the price they pay for such transport," and these consequences then flow through to "the availability (and prices)" of the wholesale service to these competing carriers and to "their customers throughout the Commonwealth."[55]

Q. IS THE IMPACT OF THE PROPOSED VERIZON/MCI MERGER ON THE AVAILABILITY OF THESE WHOLESALE FACILITIES, THE ABILITY OF VERIZON TO INCREASE RATES, OR THE DETRIMENTAL IMPACT ON BOTH RETAIL PROVIDERS AND BUSINESS CUSTOMERS ANY LESS LIKELY OR ANY LESS IMPORTANT IN WASHINGTON THAN IT IS IN NEW YORK OR VIRGINIA?

A. No. The same potential exists for a detrimental impact on both competing providers and on end-user customers. The focus on wholesale high-capacity services, including special access services, is entirely appropriate and an essential component of any meaningful analysis of "whether the merger is likely to create or enhance market power or to facilitate its exercise."

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[55] Commonwealth of Virginia State Corporation Commission Staff Report in Case No. PUC-2005-00051, August 12, 2005, p. 26.

An Examination of Verizon's and MCI's Operating and Strategic Postures B*efore* and *After* the Proposed Merger Shows That the Risk of Mutual Forbearance is Substantial and Persistent

The Commission Should Consider the Applicant's Pre-Merger Behavior and Statements of Intent

Q. CAN YOU EXPLAIN HOW THE PREMATURE TERMINATION OF MCI'S INCENTIVES IN THE BUSINESS MARKET WILL HARM COMPETITION AND RAISE CONSUMER PRICES?

A. Yes. MCI has acknowledged that its mass market business is in "irreversible decline," based in part on the demise of UNE-P. An independent MCI focused on high-capacity markets would have strong incentives to reduce dependence on ILEC facilities, would be likely to build or lease more alternative facilities, and would have a strong incentive to improve the utilization of its capacity by expanding its local wholesale operations. Because MCI already has: (1) extensive facilities in place to serve many domestic and international markets that require high-capacity facilities, (2) an extensive global Internet backbone network, and (3) suites of advanced technologies, its developmental focus would logically place emphasis on reducing dependence on ILEC local facilities. The prospect of continued dependence on ILEC local facilities (in contrast to its extensive and fully built-out long haul, global network assets) would provide MCI with clear incentives to expand its local network investment.

Despite MCI's favorable financial condition after its mass market exit, any program of building more high capacity local access facilities would not be inexpensive. As a result, the incentive for MCI to build out network components where it lacks ubiquitous network assets also carries the incentive for MCI to expand its wholesale marketing efforts. Extending its in-building facilities to provide wholesale service to

1 CLECs would be an effective method of improving the economics of building facilities in
2 both the already served building and in adjacent buildings.

3 The increased wholesale marketing would provide MCI with the revenue needed
4 to support building more high capacity facilities. In testimony submitted in this
5 proceeding and before the FCC, MCI has attempted to downplay its involvement in the
6 local access market based on its original network architecture (which was initially
7 optimized to deliver traffic to its long distance points of presence), yet MCI has already
8 developed an extensive local access network in many urban areas of MSAs.[56] Therefore,
9 absent the merger, MCI would be well-positioned to expand its wholesale operations.

10 Despite Verizon's theoretical ability to expand MCI's local network assets if the
11 merger is approved, it is a near certainty that both MCI and AT&T would expand their
12 local network assets if they remained independent. Verizon will not abandon MCI's local
13 facilities, but game theory indicates that Verizon's out-of-region behavior would be far
14 less competitive than it is now implying. Indeed, game theory coupled with the condition
15 of upward pricing flexibility authorized by some regulators (including the FCC), could
16 create an atmosphere that would virtually destroy business market competition in many
17 areas.

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[56] Data developed for XO shows that in the wholesale market for facilities offered to other service providers, MCI actually has a higher market share in some MSAs than the other large CLEC, AT&T.

1 **Q. WHY DOES VERIZON'S FIBER OPTICS CONSTRUCTION PROGRAM**
2 **INDICATE THAT THE MERGER WILL NOT HAVE THE EFFECTS CLAIMED**
3 **BY THE APPLICANTS?**
4
5 A. Whatever benefits may flow to Verizon or Verizon's customers in other states from the
6 significant expansion of broadband fiber optic facilities, this program carries its own
7 substantial disincentives against expanding the merged entity's out-of-region competition
8 with other ILECs. Faced with substantial additional capital expenditures needed to build
9 in-region facilities, and the costs of acquiring and keeping customers, Verizon is less
10 likely to expand MCI's access facilities in other regions in competition with incumbents
11 like Qwest and BellSouth, than an independent MCI would be.

12 The economic conditions that lead to mutual forbearance (implicit, but mutual,
13 non-competition) among firms in different geographic markets clearly exist for both of
14 the ILECs who have proposed mergers. Even independent analysts have commented that
15 ILECs' effort to expand their presence in-region provides strong incentives to compete
16 out-of-region only in the most selective and limited ways.[57] With SBC facing the same
17 strategic imperatives in-region and the same incentives to limit out-of-region
18 competition, it is unlikely that the two will enter into serious competition. Neither ILEC
19 can overcome the other ILEC's cost advantage its home territory, while simultaneously

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[57] "While the IXCs endured significant price competition that plagued the long distance market, we expect the RBOCs to be in a better position *to stabilize prices…they will act more rationally*, recognizing and capitalizing on the relatively scarce assets just acquired, particularly in the very large enterprise marketplace… In the SME (small and medium enterprise) space *we expect the RBOCs to capitalize on opportunities in-region where they have an access cost advantage*." Bear Stearns, "U.S. Wireline Services, The Catalyst for Consolidation. An Analysis of the Enterprise Telecom Marketplace," June 2005. (emphasis added)

expanding its in-region broadband network. This is precisely the set of conditions under which mutual forbearance is attractive, profitable, and likely to occur.

Q. DO THE ILECS HAVE STRONG STRATEGIC INCENTIVES TO MAINTAIN A MUTUAL FORBEARANCE GAME IN LOCAL ACCESS?

A. Yes. It is important for the Commission to consider both (1) why competition between ILECs has been very limited since the Telecommunications Act eliminated territorial monopolies, and (2) why this is an equilibrium condition that is self sustaining and will remain so if the mergers are completed.

Expanded out-of-region competition, particularly in the mid-sized business market, would drain an ILEC's capital resources that could be profitably committed at home. The result of expanded head-to-head competition would lead to margin-eroding price decreases. An ILEC wishing to engage in extra-territorial competition would be required to price its services well below the local incumbent in order to induce customers to switch (facilities-based CLECs in Washington are familiar with the fact that the discounts needed to acquire and retain customers can be substantial). The resulting reciprocal price competition between the home ILEC and the ILEC from another region would erode the existing significant margins for the services subject to competition.[58]

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[58] The same phenomenon occurs with smaller CLECs like XO and Covad. Incumbents like Verizon respond to smaller CLEC's competition, which is still limited geographically, by giving customers custom deals.

1 *The Existing ILEC Margins for Special Access Provide Ample Incentive for them to*
2 *Continue Mutual Forbearance if Possible*

3 **Q. WHAT ARE THE ILECS' CURRENT MARGINS ON THEIR IN-REGION**
4 **SERVICES THAT WOULD BECOME VULNERABLE TO EROSION IF THEY**
5 **COMPETE IN OTHER TERRITORIES?**
6
7 **A.** Mid-sized business customers generally use high capacity facilities for building access.
8 These local special access facilities are used by all providers that are not CLECs and thus
9 not entitled (even temporarily) to UNEs; such carriers include long distance providers,
10 Internet service providers, and the end user customers themselves. In many cases CLECs
11 must use special access facilities when UNEs are unavailable or when the CLEC cannot
12 gain access to a building or individual customer premises using UNEs.

13 An analysis recently filed in the FCC's investigation of the proposed SBC-AT&T
14 merger showed that in 2004 Verizon's average special access return was 31.6%.[59]
15 Previously, AT&T had shown that Verizon's return on these services increased from
16 22.9% in 1999 to 37.1% in 2001.[60]

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[59] FCC WC Docket 05-65, Reply Comments of the Ad Hoc Telecommunications Committee, May 10, 2005, Attachment B, "Reply Declaration of Susan M. Gately, p. 6. Noting that its members "are not competing carriers" the primary comments state that "The largest corporations that annually spend tens and even hundreds of millions of dollars on local and long distance, voice and data telecom services have long been assumed to be the primary beneficiaries of competition in all telecom sectors. Surprising as it may be … in most locations, *enterprise customers have no access options other than the services and facilities that are available exclusively from ILECs* [and] the enterprise customers' marketplace experience is at odds with the rosy picture painted by the BOCs for several years in their filings with this Board. Any merger analysis that fails to look past rhetoric to the factual record regarding the state of competition in SBC's special access marketplace will disserve the public interest." Reply Comments, pp. 3 and 9 (emphasis added).

http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6517601224

[60] AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, RM-10593, filed Oct. 15, 2002 ("AT&T Special Access Rate Petition"), attached Declaration of Stephen Friedlander, Exhibit 1.

Each ILEC that seeks to compete with another ILEC risks placing its large in-region margins at risk. CLECs do not face this same consideration because they have no "home territory" with a large and profitable base of customers. Instead they have to compete vigorously in all potential locations in order to survive.

Q. ARE TWO ILECS LIKELY TO TRY TO COMPETE WITH EACH OTHER?

A. No. An ILEC's vigorous and expansive out-of-region competition (even if it were affordable to build the necessary facilities and market the products), would lead to destructive retaliatory price wars as the out-of-region ILEC competed away profits from prime customers. This outcome is compounded by the fact that destructive competition would render the home ILEC's basic counter-strategy unsustainable.

The traditional counter-strategy has been for home ILECs to increase prices for customers who lack competitive options. Each ILEC would attempt to offset lost margin from the other's competition by increasing its own realized margins on its remaining customers. Under a deregulatory regime or one allowing upward pricing flexibility (as both SBC and Verizon currently enjoy at the federal level), such a strategy is possible. The price increases, however, would clearly repress demand and ultimately might make otherwise uneconomic market entry attractive in those non-competitive sectors. This is not a sustainable equilibrium condition.

Even if both of the home ILECs had sufficient flexibility to raise prices for customers with no competitive choices, the more rational behavior would be for both to forego out-of-region competition and significantly limit any rivalrous behavior. Rather than using its pricing flexibility in a vain and ultimately unsustainable effort to impede

1 the eroding margins, each ILEC would more rationally conclude that the optimum
2 behavior is to use its pricing flexibility in order to maximize its profits in-region, and
3 continue the practice of mutual forbearance against the other ILEC in the second ILEC's
4 home territory.
5
6 **Q. IS THIS HOW THE GAME ACHIEVES A SUSTAINABLE EQUILIBRIUM?**
7
8 A. Yes. The clearest, best way to do this is for each ILEC to adhere as closely as
9 commercially possibly to "business as usual." Each ILEC will compete for new out-of-
10 region customers (customers not already served by the CLEC it acquired), only in a very
11 limited way, and real growth in competition between regions will be the exception if it
12 exists at all. Of course, each ILEC will almost certainly be able to produce token
13 examples of "competition," but this is illusory competition (undertaken on a limited basis
14 in order to influence regulators) and not a state of continuous, sustainable competition
15 that will discipline prices.
16 In the end, the most sustainable post-merger condition looks remarkably similar to
17 the very limited inter-territorial competition that exists before the proposed merger.
18
19 **Q. IS THERE EVIDENCE THAT THE ILECS WANT TO AVOID DISRUPTING**
20 **THE EQUILIBRIUM IN THIS MANNER?**
21
22 A. Yes. The bidding war for MCI in which Verizon and Qwest engaged for several months

1 provides one such example.[61] Verizon first agreed to acquire MCI for $5.2 billion. MCI
2 had agreed to Verizon's initial offer in mid-February, so the $5.2 billion price
3 presumably reflected an appropriate valuation given all that was known then about MCI's
4 present and future business. This valuation would, of course, consider whatever realistic
5 prospects MCI had to expand its business over time, both domestically and
6 internationally, as well as MCI's existing assets such as its Internet backbone. When
7 Qwest opened the competition by bidding for MCI, Verizon raised its offer to $6.7
8 billion. Later Verizon purchased a 13.4% minority interest in MCI from a single
9 shareholder for $1.1 billion, implying that MCI's market value could be as high as $8.2
10 billion. With the main $6.7 billion offer still on the table, Verizon threatened on April 4,
11 2005 to walk away from buying MCI. Then, under pressure from Qwest (which lodged a
12 new $8.4 billion bid), Verizon raised its proposed payment to $7.6 billion and ultimately
13 concluded by agreeing to a price of $8.5 billion. Qwest proposed another offer at $8.9
14 billion and was at $9.7 billion when MCI accepted Verizon's lower offer, over objections
15 from some MCI shareholders.[62]
16 Verizon eventually raised its offer for MCI by over 63% and Qwest was prepared
17 to pay 86.5% more than Verizon initially offered. Assuming Verizon's initial offer,
18 accepted by MCI, reflected the appropriate valuation of MCI, a question remains: what

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[61] The proposed SBC/AT&T merger is highly relevant to the mutual forbearance issue. SBC cemented its deal with AT&T first and thus enjoyed a unique "first mover" advantage; SBC did not confront a bidding war and thus did not have to publicly reveal the value it placed on a continuation of the mutual forbearance game. Verizon, however, as the "second mover," got caught in an auction for MCI and thus was forced to publicly expose its estimate of the value of controlling an asset (i.e., MCI) which would help protect it from any out-of-region competition by SBC/AT&T. Comparison of the two mergers could not be more economically relevant to examining adverse competitive effects.

[62] This information is fully documented in both *TR Daily* online and *Wall Street Journal* online.

led to MCI's price to be bid up between an additional $3.3 billion and later an additional $4.5 billion?[63] One legitimate answer is that Verizon needed MCI in order to maintain the existing mutual forbearance.

This history suggests that the extra $3.3 billion Verizon was willing to tender for MCI reflects the internal valuation of the net present value to the company of maintaining any profits Verizon might earn under business as usual; the $3.3 billion certainly does not represent a sudden appreciation of MCI's assets. Verizon ultimately viewed MCI as a valuable defensive asset against SBC/AT&T, because an independent MCI – as a third party with very different incentives – would have complicated and possibly precluded continuation of the ILECs' long standing mutual forbearance strategy.

Q. SHOULD THE COMMISSION RECOGNIZE THAT THE LIKELIHOOD OF MUTUAL FORBEARANCE IS ONE OF THE COMPETITIVE EFFECTS OF THE VERIZON-MCI MERGER?

A. Yes. One of the consequences of increased market concentration recognized in the Merger Guidelines is the increased likelihood of interdependent tacit collusion. For the reasons that I described above, this merger threatens to create precisely such a situation. The Commission should, therefore, weigh Verizon's general suggestion that it will engage in true competition both in- and out-of-region on one side of the scale, against the economic near-certainty than an independent MCI, focused on the high-capacity business market, would seek to reduce its dependence on ILEC local access facilities. These local

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[63] Qwest's claim to the FCC that it had different motives for attempting to acquire MCI seems to have some credibility because Qwest's much less dense operating region would appear to be a less tempting target for out-of-region competition by SBC than Verizon's highly urbanized East Coast markets – competition which, if it occurred which would break the pre-existing equilibrium.

1 access facilities are virtually the only asset that an independent MCI needs for its
2 business market strategy that it does not currently control. In order to make this
3 replacement strategy for ILEC local facilities as cost effective and rapid as possible, MCI
4 would seek all available methods to share the costs of deploying its own facilities to new
5 locations.

6 Expanding its wholesale offerings of access facilities to other providers would be
7 the most obvious strategy to defray these costs. For example, MCI's Type 2 access
8 facilities (a service which MCI provides on its own facilities for part of the necessary
9 local transmission links and leases only part from the ILEC as special access today)
10 would be prime targets for the ILEC replacement strategy. Other clear targets would
11 include those buildings in which MCI's existing facility now is routed to a single
12 customer's office, buildings adjacent or near to one of MCI's local fiber rings or campus
13 like building clusters would likely be upgraded.

14 Finally, an independent MCI's likely strategy for serving the business market is
15 not the only weight on the side of the scale against Verizon's general indication of its
16 future out-of-region competition. One must also weigh the mutual forbearance game in
17 which the ILECs have long engaged and which they have strong incentives to continue to
18 play.

The Withdrawal of MCI as a Current and Future Competitor Offering Wholesale Building Access Services Will Cause Prices to Increase and End Users' Service Options to Decrease

Q. PLEASE EXPLAIN HOW THE FACTORS DISCUSSED IN THE PREVIOUS SECTION ARE LIKELY TO IMPACT WHOLESALE PRICES FOR HIGH-CAPACITY SERVICES.

A. Based on the concepts of the Merger Guidelines, it is essential that the market or markets for this analysis be fully defined. The market at issue here, though largely ignored by Verizon and MCI in their presentation, is the market for mid-sized business customers that rely on high capacity (DS1-level and above) building access facilities, including transport facilities. These facilities are used to supply service to business end users in the medium-sized market that can be served efficiently using at least DS1-level capacity facilities.

Without competition in this segment, these access and transport facilities would be supplied as special access services, which are currently priced to generate a significant margin for the ILECs. Recently implemented and pending regulatory matters make it unlikely that these requirements can be satisfied by loop and transport UNEs – particularly for longer "non-transitory," time periods considered in a merger analysis.

Finally, the proposed mergers would remove the largest CLECs, MCI (and probably AT&T) from the current role of significant suppliers in the market of wholesale facilities to other service providers, including other CLECs. MCI would be eliminated from the market just when its reduced focus on the residential market provides it with stronger incentives to expand retail services business end users and, wholesale services, to CLECs. Both economic theory and practical reality show that there is little likelihood that the new "mega-carriers" would significantly expand their out-of-region competition

1 with other ILECs in the mid-sized business market because such competition would place
2 their significant margins on in-region business services at risk.
3

4 *The Decline in Wholesale Alternatives Created by the Proposed Merger Will Directly*
5 *Impact End-User Business Customers*

6 **Q. IS IT POSSIBLE TO IDENTIFY THE IMPACT OF THESE CONDITIONS ON**
7 **BUSINESS CUSTOMERS?**
8
9 A. Yes. Such an estimate requires three types of information: (1) a consideration of the
10 extent of MCI's deployment of building access facilities today and in the future without
11 the merger (so that MCI is focused on the enterprise market), (2) a consideration of how
12 MCI's extensive, global intercity network and its historic focus on providing complete
13 network facilities to business customers allows it to install facilities in larger capacities
14 than smaller CLECs, thus making MCI (and the only other U.S. provider with such scale,
15 AT&T) uniquely positioned to place significant wholesale price pressure on ILECs'
16 access services, and (3) a consideration of how removing MCI from the wholesale
17 market will raise *competing bid prices* for alternatives to ILECs services, thereby raising
18 end users' rates.
19

20 **Q. PLEASE DESCRIBE MCI'S DEPLOYMENT OF BUILDING ACCESS**
21 **FACILITIES.**
22
23 A. Although not as ubiquitous as an ILEC's network, MCI has deployed extensive local
24 access facilities today, both to its own retail customers and to other carriers on a
25 wholesale basis. MCI provides wholesale facilities to other carriers on two conditions (1)
26 if it can provide the entire circuit over its own facilities (the customer premises or other

1 building access connections) at both ends of the circuit and the transport facility in the
2 middle (referred to as "Type I" circuits), or (2) it can provide part of the circuit
3 components and utilize the ILEC's discounted special access for the remaining parts of
4 the circuit, typically one of the location-connecting loop access facilities ("Type II"
5 circuits). Data showing which particular individual buildings are served by specific
6 facilities-based telecommunications providers are available both in proprietary
7 commercial databases, and in "lit building" lists maintained and frequently updated by
8 many CLECs, including AT&T and MCI.[64]
9

10 **Q. WHY IS THE EXTENT THAT MCI HAS FACILITIES INTO SOME**
11 **BUILDINGS SIGNIFICANT?**
12
13 A. As discussed above, MCI's increased focus on the high-capacity business market, due in
14 part to the erosion of mass market services, would provide MCI with both the incentives
15 and resources to convert its existing Type II circuits (those owned only in part by MCI
16 itself) into fully-owned facilities over time. MCI would have the economic incentive to
17 expand its existing wholesale operations in order to add the new wholesale and retail
18 revenue streams necessary to expand the reach of its Type I facilities. In contrast, an
19 MCI acquired by Verizon has the incentive to cease provisioning wholesale loop and
20 transport circuits that compete with, and would undercut the pricing of, Verizon's special
21 access services.

[64] Both SBC and Verizon have used their own lists as well as the commercial databases in federal and state specific proceedings dealing with the "impairment" issue under the 2002-03 TRO investigation.

1 In addition, the facilities used by MCI are often of much higher bandwidth than
2 smaller CLECs can economically provision. The extent that separate MCI-provided
3 building access will be eliminated by the proposed merger is an important consideration.
4 An impact analysis must consider both the number of buildings that MCI serves and the
5 relatively large bandwidth capacities that MCI can deploy or acquire because of the
6 number and size of its customers. Bandwidth requirements are a determinant of whether
7 MCI uses some of its own facilities to reach particular buildings or uses Verizon special
8 access to reach them.
9
10 **Q. YOU SAID THAT MCI USES FACILITY BANDWIDTHS THAT SMALLER**
11 **CLECS CANNOT AFFORD. HASN'T THE FCC DETERMINED IN THE *TRO***
12 **AND *TRRO* THAT HIGHER BANDWIDTHS NEED NOT BE UNBUNDLED, *I. E.***
13 **THAT THERE IS NO "IMPAIRMENT" AT THAT LEVEL?**
14
15 A. Yes. In the *TRO* the FCC determined that all OC*n* (*n* being 3, 12, 48 or whatever the
16 equipped capacity of the pipe) were no longer impaired, and then it extended this
17 limitation to dark fiber facilities in the TRRO. Unfortunately, the FCC's determination
18 was based on its cost analysis on the *supply side*, in which it determined that if any
19 service provider had a reason to extend an OC*n* equipped fiber optic line to a particular
20 building, that provider should be able to bear the costs of the permitting, engineering,
21 installing and completing other steps needed to self-supply the line. This finding,
22 however, is not a *demand side* analysis. Implicit in the FCC's determination is the
23 assumption that the CLEC in question would have requisite customer demand to build
24 that pipe in the first place. A CLEC who lacked sufficient demand and whose market
25 focus fell on relatively smaller customers would fail the demand-side requirements. The

1 FCC's finding thus applies to providers who have the network scale to serve to serve
2 large enterprise customers and who target customers with multiple (and perhaps
3 worldwide) locations.. The finding, in other words, is directed at AT&T and MCI, and is
4 not germane to many CLECs who target mid-sized business customers.

5 In contrast, the limits established in the *TRRO* regarding impairment of DS1
6 loops, DS3 loops, and dedicated transport - such as limiting non-impaired DS1 loops to
7 wire centers with at least 60,000 business access lines – do represent the FCC's demand
8 side analysis for CLECs serving smaller customers. The impairment criteria applied by
9 the FCC to DS1 and DS3 loops allowed CLECs targeting the mid-sized business market
10 continued access to high-capacity loop UNEs and dedicated transport based on *demand*
11 conditions in each particular market.[65]
12

13 **Q. HOW DO THE GREATER BANDWIDTHS THAT MCI CAN USE – DUE TO**
14 **THE SCALE OF ITS NETWORK AND THE LARGER CUSTOMERS IT**
15 **SERVES – INFLUENCE THE MERGER ANALYSIS?**
16
17 A. There are several effects. First, when the buildings served by MCI (or AT&T) are
18 disaggregated by various levels of bandwidth, the data indicate that the share of buildings
19 that large CLECs serve increases with the bandwidth of the facility they use to provision
20 service. An ongoing analysis of building data conducted by XO and other CLECs in the
21 FCC proceeding shows that in several MSAs, the largest CLECs penetrate only about 6%
22 of the buildings where marketing databases indicate the total telecommunications demand
23 at the site could be handled by at least one DS1-level circuit (1.544 Mbps). On the other

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[65] Of course, Verizon made the FCC's test obsolete even before the TRRO was officially published – simply by entering into the merger agreement.

1 hand, when the indicated demand can only be satisfied by one or more OC3 (155.520
2 Mbps) circuits, the largest CLECs' share exceeds 13%. When the minimum
3 telecommunications demand in a building is an OC3 circuit with over 100 times the
4 capacity of a DS1, MCI or AT&T are much more likely to have penetrated the building.
5 The relative bandwidth needs of different size customers clearly do affect the ability of
6 larger versus smaller CLECs to address the wholesale market, and are a relevant part of
7 the merger analysis

8 Second, it's quite rare for the telecommunications demand for a single customer
9 or building to utilize precisely 100% of the capacity of a circuit (nominally 24 lines for a
10 DS1 or 2016 lines for an OC3 circuit). Therefore, the larger the equipped circuits for
11 which MCI (or AT&T) has the end user demand needed to justify installing the circuit,
12 the greater the amount of spare, unused capacity that exists in the circuit. If, for example,
13 MCI's large enterprise customer in a building requires 1500 lines in MCI's OC3 facility
14 to that building, MCI still has the equivalent of over 500 voice grade channels of capacity
15 left over (more than 20 DS1s). Even after allowing for demand growth by its principal
16 customer, MCI would still have multiple DS1s worth of spare transmission capacity. It is
17 this capacity that an independent MCI would seek to leverage by expanding its wholesale
18 operations to CLECs whose main business focus is mid-sized business customers.[66]

19 This same analysis applies to transport facilities between ILEC wire centers, not
20 just the loop and transport facilities included as part of a circuit dedicated to accessing a

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[66] It is not just MCI's *static* excess capacity condition that creates the incentive to expand its wholesale operations. With respect to the OC3 facility in the example, it's also quite relevant that MCI could double or quadruple the capacity of the facility at relatively low incremental costs (i.e., to an OC6 or OC12 level) and thereby significantly expand the capacity that it has available to offer at wholesale.

particular building. Competitors like XO and Covad collocate in multiple ILEC central offices to access UNEs and special access circuits from the ILEC, as well as to cross-connect to the facilities of other carriers who are also collocated in that office. The networks of such competitors other than MCI, however, often do not include transport between collocated facilities in other ILEC central offices. As an alternative to obtaining transport from the ILEC for this purpose, competitors may have access to transport provided by MCI that it has constructed as part of either its local or long distance network. Again, where MCI has constructed OCn level facilities with significant excess capacity, an independent MCI would seek to leverage such spare capacity by making it available to smaller carriers.

Finally, the understanding of how MCI's bandwidth demand affects the issues in this case leads to the third part of the analysis: How an independent MCI's role affects the pricing of wholesale transport and access services and how the merger will lead to higher prices for Washington customers.

The Removal of Competitive Alternatives Will Eliminate and Foreclose Downward Pressure on Verizon's Prices for High-Capacity Services

Q. CAN YOU EXPLAIN WHY THE PROPOSED MERGER WILL REDUCE COMPETITIVE PRICING PRESSURE ON VERIZON?

A. Yes. The adverse effect on wholesale prices occurs in two ways. First, the economic incentives created by MCI's higher demand potential and greater excess bandwidth means that an independent MCI's pricing incentive is to cover only the average variable costs (plus a reasonable return) of the spare capacity on its own facilities. If it can price at this level, the revenue stream is essentially "found money." This condition makes it

feasible for MCI to significantly under price the ILEC special access service where MCI owns even *part* of the circuit serving a building.

Second, MCI has both the scale of operations and access to capital required to provide a credible threat that at some point it will build around Verizon's network on a wide scale basis, and thus have some bargaining leverage with respect to the purchase of special access services. These MCI discounted special access contracts benefit the broader competitive market in two ways. Where other carriers can satisfy the volume and term requirements in a special access deal, the RBOCs must offer them a similar contract because of the common carrier duty not to discriminate. More importantly, however, the benefits of discounted purchases of special access services by MCI are passed through to other carriers when the large CLECs bid to sell high-capacity circuits on a wholesale basis. In this way, the benefits derived from the negotiating leverage of MCI are passed through to the broader competitive carrier community and ultimately to their downstream end user customers.

Q CAN YOU PROVIDE AN EXAMPLE OF HOW THE COMBINATION OF MCI'S LOGICAL WHOLESALE PRICING, TOGETHER WITH ITS ABILITY TO REALIZE SPECIAL ACCESS VOLUME DISCOUNTS, DRIVES DOWN BOTH WHOLESALE AND END USER RATES?

A. Yes. Assume that the monthly recurring rate in the ILEC special access tariff for a local circuit consisting of two loops (channel terminations), interoffice mileage and certain features and functions specified by the potential customer comes to $6,000. Competitive Bidder #1 tries to undercut the ILEC's posted (tariff) price but still maximize its profits and thus bids $4,000 for the identical circuit configuration, because competitive Bidder

1 #1 does not know what price competitive Bidder #2 might quote. In this case though,
2 competitive Bidder #2 has different incentives than does competitive Bidder #1. Since
3 Bidder #2 already has high capacity facilities in place on the route covered by the ends
4 user's RFP, and because Bidder #2 is a larger service provider and thus carries much
5 more traffic than competitive Bidder #1, it only looks to cover the average variable costs
6 of its excess capacity plus a reasonable return. Therefore Bidder #2 may quote only
7 $3,000 for the circuit, thereby providing a discount to the customer.

8 The same scenario also demonstrates the *adverse* price effects of the proposed
9 merger. If competitive Bidder #2 exits the market, the lowest price that the end user will
10 be quoted under its RFP increases in the first instance by $1,000 (Bidder #1's $4,000
11 minus Bidder #2's $3,000). Unfortunately there is a secondary effect that has been
12 identified by economic theory with respect to auction markets.

13 In the new scenario, Bidder #1 wins with its $4,000 bid, but, over time, it begins
14 to understand that the ILEC's posted prices are its only real competition. Bidder #1
15 continues to collect information from the posted prices. Then, when a similar end user
16 issues a new RFP for the same type of circuit configuration, the profit maximizing Bidder
17 #1 quotes a price just below the ILEC's posted price, $4800 for example. Thus the total
18 impact of Bidder #2's exit from the wholesale market is $1,000+$800 or $1,800 per
19 month on the *ultimate consumer* ($4800 minus Bidder #2's offer in the first instance of
20 $3000). Thus, the *lowest price* in the bid market has risen from $3,000 to $4,800 – fully
21 a 60% increase to the retail ratepayer.

22 This sort of price inflation occurs even if there are no coordinated effects in the
23 post-merger market, i.e., if Bidder #1 is an entirely independent supplier with unfettered

1 profit maximizing incentives. If, on the other hand, Bidder #1 could achieve higher
2 margins in another area, the economic incentives for mutual forbearance would cause
3 Bidder #1 not to offer the customer any bid if Bidder #1's new parent chooses not to
4 commit its scarce capital resources out of region. For this reason, any new competitive
5 forays against the entrenched ILEC will be extremely limited.
6
7 **Q. WOULD THIS OCCUR IN THE CURRENT CASE?**
8
9 A, Yes. Verizon has sometimes suggested that, even if MCI exits the local market because
10 of its acquisition by Verizon, other carriers, including AT&T, will stay and compete with
11 the incumbent. For the reasons given previously in my testimony, it is highly unlikely
12 that a combined SBC/AT&T entity will aggressively compete out-of-region for the mid-
13 sized business market (either wholesale or retail). Even if it did, the removal of MCI as a
14 price competitor will change AT&T's pricing incentives in precisely the way described
15 above.
16 In the current market, when AT&T places a competitive bid it knows that it must
17 take into account the possibility that MCI will be bidding against it and AT&T's bid price
18 will reflect the actual or potential bid by MCI. With MCI removed from the market,
19 AT&T's bid is significantly more likely to be designed to respond to the Verizon special
20 access price – a price that is typically much higher than the bid price that MCI would
21 offer. Hence, even if AT&T were to stay in the mid-sized business market, the removal
22 of MCI would cause its rates, and thus rates to both wholesale and retail customers, to
23 increase.
24

The Commission Should Adopt a Minimum Set of Conditions in Order to Mitigate the Adverse Effects of the Proposed Merger

Q. WHAT SHOULD THE COMMISSION DO IN ORDER TO PREVENT THE COMPETITIVE HARMS YOU HAVE DISCUSSED?

A. The evidence demonstrates that the unrestricted acquisition of MCI by Verizon is highly likely to lead to diminished competition in the local business markets served by CLECs competing on the basis of loop and transport arrangements. The anticompetitive effects will happen both directly in the retail market and indirectly by the diminution of wholesale competition by MCI. The harm is directly attributable to the effective removal of MCI as an existing competitor in the wholesale market, and an even more significant future competitor as an independent provider to the high-capacity business markets. The damage is inflicted in several interrelated ways, each of which requires in own mitigation measures.

The most efficient remedy for dealing with these and other competitive harms from the Verizon-MCI merger is to simply forestall the transaction, as antitrust regulators did with the proposed WorldCom-Sprint merger several years ago. However, if the merger is approved, even in part, substantial mitigation measures will be required. These remedies require action by this Commission as well as the FCC and DOJ's Antitrust Division.

Q. CAN YOU SUMMARIZE THE MITIGATION MEASURES XO AND COVAD ARE PROPOSING?

A. Yes. Several steps are needed to mitigate the adverse price impacts from the Verizon-MCI merger. The Commission should undertake actions to ensure that CLECs have

1 some stability in their contracts and dealings with Verizon and other ILECs. The non-
2 exclusive conditions I discuss below should be imposed and apply for a minimum of five
3 (5) years after each proposed merger transaction is completed.
4
5 **Q. ARE THE REMEDIES YOU DISCUSS THE ONLY ONES THAT SHOULD BE**
6 **APPLIED TO THE VERIZON-MCI MERGER?**
7
8 A. Not necessarily. XO/Covad witness Joseph Gillan has presented a proposal for the
9 application price caps on certain Verizon services. I fully support his suggestions as a
10 means of limiting harm from the proposed merger. These price caps will serve as one
11 way to combat increased concentration and the results of anti-competitive incentives
12 among the two "mega-carriers" created by the parallel mergers.
13 I have not attempted to analyze the market effects of the proposed mergers on
14 other telecommunications markets, but other parties may have done so and may have
15 important points to make. I want to be clear that XO and Covad's particular analysis of
16 the merger, and the mitigation measures that I discuss, probably do not exhaust either the
17 full range of possible competitive harms from the merger or all remedies that would be
18 necessary to mitigate such harms.
19
20 **Q. SHOULD THE COMMISSION TAKE OTHER STEPS TO BENEFIT**
21 **WASHINGTON END USER CONSUMERS?**
22
23 A. Yes. In its *TRRO* decision, the FCC began the process of phasing out high-capacity loop
24 and transport UNEs on the supposition that MCI (and AT&T) would compete with each
25 other to provide wholesale services on routes where UNEs are eliminated. The proposed
26 Verizon-MCI merger (like the SBC-AT&T merger) fundamentally undermines what the

1 FCC was attempting to do. As I noted above, the significant price increases for high-
2 capacity building access that are likely to be a *direct* result of the elimination of an
3 independent MCI from the market, are also *indirectly* affected by past FCC pricing
4 flexibility decisions for ILEC special access services.

5 The FCC has open proceedings concerning possible reconsideration of the *TRRO*
6 and the current special access pricing rules. However, the acquisition of MCI (and
7 AT&T) makes the problems identified materially more immediate and acute with respect
8 to Verizon (and SBC) than with other ILECs. These merger-specific harms must be
9 resolved before the proposed merger should be found to be in the public interest of
10 Washington ratepayers, including but not limited to mid-sized business customers.
11

12 *Specific Steps to Be Taken by the Commission in Order to Mitigate the Adverse Impact of*
13 *the Proposed Merger*

14 **Q. CAN YOU EXPLAIN MORE SPECIFICALLY WHAT THE COMMISSION**
15 **SHOULD REQUIRE VERIZON TO DO BEFORE GRANTING VERIZON'S**
16 **MERGER APPLICATION?**
17
18 A. Yes. First, Verizon should be required to treat AT&T and MCI as non qualifying fiber-
19 based collocators and then to recalculate the locations where Section 251 High Capacity
20 loop, transport, and dark fiber UNEs are provided. In the *TRRO*, the FCC revised its
21 UNE rules to eliminate the ILEC obligation to provide high capacity UNE loops where
22 certain conditions are met, with one condition being the presence of four fiber-based
23 collocators.[67] Similarly, high capacity and dark fiber dedicated transport UNEs were

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[67] 47 CFR § 51.319(a)(4)-(5).

1 eliminated where three or four fiber based collocators are present.[68] A fiber-based
2 collocator, defined to include only carriers that are "unaffiliated with the incumbent
3 LEC,"[69] were used to measure wholesale competition by determining whether multiple
4 *non-ILEC* facilities-based competitors were in place. However, under the current rules,
5 these "non-impairment" findings are *permanent* even if wholesale competitors in the area
6 are eradicated.[70] Verizon effectively engaged in an end-run around the FCC tests by
7 counting MCI as a fiber based collocator and relying on its presence to render certain
8 wire centers as "non-impaired," and then almost immediately thereafter seeking to
9 acquire MCI and *eliminate* its competitive presence. The absorption of MCI and AT&T
10 by the RBOCs wholly undermines the theoretical and factual underpinnings of the *TRRO*.
11 To remedy this situation, action must be taken to restore the availability of
12 wholesale facilities in affected areas at rates comparable to those which would have
13 prevailed had an independent MCI continued to compete in the market. Verizon should
14 be required to recalculate - prior to any merger decision - the locations where impairment
15 for high capacity loops and high capacity transport exists, without counting either MCI or
16 AT&T as a qualifying fiber-based collocator.

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[68] 47 CFR § 51.319(d)(3)

[69] 47 CFR § 51.5.

[70] For example, the *TRRO* rules state, "Once a wire center exceeds both of these thresholds, no future [DS1 or DS3] loop unbundling will be required in that wire center." Section 51.319 (a) (4) and (5).

Q. SHOULD THE COMMISSION TAKE ANY OTHER ACTIONS BEFORE APPROVING THE APPLICATION?

A. Yes. The Commission should also require Verizon to waive the cap on DS1 loops and transport circuits. As part of the FCC's misplaced assumption that the two largest CLECs would continue to contribute to the development a robust wholesale market, the TRRO placed a cap of 10 on the number DS1 unbundled loops and dedicated transport circuits that could be ordered to a building or on a particular route.[71] Verizon should be required to waive these caps to ameliorate the anticompetitive effect of the loss of MCI as a meaningful participant in the wholesale market. As I previously stated, the Commission should also adopt for Verizon the price cap proposal offered by Covad through the testimony of Mr. Gillan (see pages 35 through 42 of the Gillan testimony).

Q. YOU HAVE DISCUSSED STEPS NEEDED TO ENSURE PRICE STABILITY FOR INDEPENDENT CLECS. ARE ANY OTHER CONDITIONS NEEDED TO STABILIZE THE COMPETITIVE MARKET?

A. Yes. To function and survive as local service competitors, CLECs need not only commercially reasonable rates, terms and conditions, they also need stability of each of these variables in order to plan, acquire capital, and build business cases. Therefore, the Commission should allow CLECS to reinitialize all existing interconnection agreements with their current provisions, subject only to Commission approved adjustments to reflect recent changes in law. In addition, CLECs should have the option of opting into the most recent AT&T and MCI interconnection agreements with Verizon (even if these contracts have expired). CLECs should receive the benefit of AT&T's and MCI's ability and prior

[71] 47 CFR. § 51.319(e)(2)(ii)(B).

1 willingness to arbitrate an agreement that is not as one-sided as Verizon's current
2 template ICA.
3 Currently there are few, if any, interconnection agreements between Verizon and
4 CLECs that are not expired. Verizon's negotiation and arbitration strategy for dealing
5 with CLEC efforts to acquire new ICAs is akin to trench warfare. Even though most
6 CLECs would probably be happy to enter into a new term for their current
7 interconnection agreements or opt in to the most recent AT&T or MCI agreements,
8 Verizon has generally refused to consider such requests. In doing so, it has made the
9 negotiation and arbitration process a barrier to competition. The existing contracts are, in
10 general, presumptively just, reasonable and consistent with the requirements of the
11 Telecommunications Act because each was either negotiated with Verizon or arbitrated
12 by the Commission.
13 After the merger, CLECs must compete in a market where Verizon is larger, faces
14 significantly weaker competition, and no longer has MCI across the table from it in ICA
15 negotiations. Considering this environment, the Commission can and should direct
16 Verizon to enter into new terms for a time period longer than the two-year terms that
17 applied in the past, and should do so *before* the significant changes in market conditions
18 created by the new "non-impairment" rules and the two parallel mergers occur. A term
19 of 3 to 5 years would be reasonable. Furthermore, the Commission should limit Verizon-
20 CLEC arbitrations only to those changes of law arising out of the TRO and TRRO, and
21 should establish uniform contract amendment provisions that will apply to the new,
22 restructured agreements going forward.

1 **Q. ARE XO AND COVAD ADVOCATING THAT THE COMMISSION ORDER**
2 **DIVESTITURE OF SELECTED ASSETS SUBJECT AS A CONDITION OF THE**
3 **PROPOSED MERGER?**
4
5 A. No. However, it should be recognized that DOJ has shown a preference for structural
6 remedies such as asset and customer divestitures in telecommunications merger cases
7 under the last two Presidential administrations. Antitrust authorities have reviewed a
8 number of proposed mergers in the telecommunications industry in the last decade,
9 including the MCI-British Telecom, MCI-WorldCom, WorldCom-Intermedia, and the
10 AT&T-TCG mergers, and in each of these matters, DOJ imposed significant mitigation
11 measures as pre-conditions to approving the mergers. These mitigations included asset
12 divestitures, modification of contracting requirements, and transfers of customers. There
13 is at least a reasonable possibility that DOJ will seek some kind of similar divestiture
14 remedies, including some with financial, service quality and competition implications in
15 Washington.
16

17 **Q. CAN YOU SUMMARIZE WHAT THE COMMISSION SHOULD DO TO**
18 **PREVENT COMPETITIVE HARMS FROM THE PROPOSED VERIZON-MCI**
19 **MERGER?**
20
21 A. Yes. The set of conditions I have described are tailored to specifically address and
22 provide partial remedies to the merger-specific harms posed by the proposed
23 Verizon/MCI (and SBC/AT&T) combination. While the conditions are by no means a
24 perfect substitute for the evolving pricing discipline provided by an independent MCI
25 (and AT&T) in the wholesale market today, imposition of the full set of the conditions I
26 discuss represent a "second best" solution (assuming that the proposed mergers are
27 ultimately approved).

1 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**
2
3 A. Yes.