

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Merger of the Parent )  
Corporations of Qwest Communications )  
Corporation, LCI International Telecom ) Docket No. UT-991358  
Corp., USLD Communications Inc., )  
Phoenix Networks, Inc. and U S WEST )  
Communications, Inc. )

**Rebuttal Testimony of Dr. William E. Taylor**

**on behalf of**

**U S WEST Communications, Inc.**

**and**

**Qwest Communications International Inc.**

**February 22, 2000**

**TABLE OF CONTENTS**

**I. INTRODUCTION AND SUMMARY ..... 0**

**II. THE MERGER DOES NOT INCREASE THE LIKELIHOOD OF CIRCUMVENTING  
REGULATION ..... 0**

**III. THE MERGER DOES NOT INCREASE THE LIKELIHOOD OF ANTI-COMPETITIVE  
BEHAVIOR ..... 0**

    A. .... THE MERGER DOES NOT INCREASE THE LIKELIHOOD OF PRICE DISCRIMINATION0

    B. .... THE MERGER DOES NOT INCREASE THE LIKELIHOOD OF NON-PRICE DISCRIMINATION0

**IV. THE MERGER WILL NOT REDUCE ACTUAL OR POTENTIAL COMPETITION ..... 0**

**V. THE BENEFITS FROM THE U S WEST/QWEST MERGER ARE LIKELY TO BE SUBSTANTIAL0**

## **Rebuttal Testimony of William E. Taylor**

### **I. INTRODUCTION AND SUMMARY**

**1 Q. What is your name, business address and current position?**

**2 A.** My name is William E. Taylor. I am Senior Vice President at National Economic  
**3** Research Associates, Inc. (NERA), head of its telecommunications practice and of its  
**4** Cambridge office, located at One Main Street, Cambridge, Massachusetts 02142.

**5 Q. Please describe your educational and professional qualifications.**

**6 A.** I have been an economist for over twenty-five years. I received a B.A. degree in  
**7** economics (Magna Cum Laude) from Harvard College in 1968, a master's degree in  
**8** statistics from the University of California at Berkeley in 1970, and a Ph.D. in  
**9** Economics from Berkeley in 1974, specializing in industrial organization and  
**10** econometrics. I have taught and published research in the areas of telecommunications  
**11** policy, microeconomics, and theoretical and applied econometrics at (among other  
**12** academic institutions) Cornell University, the Catholic University of Louvain in  
**13** Belgium, and the Massachusetts Institute of Technology, and (among other  
**14** telecommunications research organizations) at Bell Laboratories and Bell  
**15** Communications Research, Inc. I have participated in proceedings before numerous  
**16** state public service commissions, the Canadian Radio-Television and  
**17** Telecommunications Commission, the Federal Communications Commission and state

1 and federal legislative bodies on various topics in telecommunications economics,  
2 including public interest assessments of mergers of major local, long distance and cable  
3 suppliers. A copy of my vita listing publications and testimonies is attached as Exhibit  
4 WET-1.

5 **Q. What is the purpose of your rebuttal testimony?**

6 A. U S WEST Communications, Inc. (“U S WEST”) and Qwest Communications  
7 International Inc. (“Qwest”) have asked me to respond to claims in the pre-filed direct  
8 testimony that the proposed U S WEST/Qwest merger (“the merger”) would harm  
9 consumers by increasing the incentive and ability of U S WEST to circumvent  
10 regulation, increasing the likelihood of anti-competitive behavior, and removing an  
11 actual and potential competitor from the market. My testimony specifically addresses  
12 the direct testimonies of Drs. Bridger M. Mitchell and Sarah J. Goodfriend on behalf of  
13 McLeodUSA Telecommunications Services, Inc. (“McLeodUSA”), Mr. Charles L.  
14 Ward on behalf of AT&T Communications of the Pacific Northwest, Inc (“AT&T”),  
15 and Dr. Glenn Blackmon of the Washington Utilities and Transportation Commission  
16 Staff (“Commission Staff”).

17 **Q. Please summarize your testimony.**

18 A. These assertions of Drs. Mitchell, Goodfriend, Blackmon, and Mr. Ward are incorrect.  
19 As I explain below, the merger will not increase the merged company’s ability or

1 incentive to engage in anti-competitive behavior or circumvent regulation, nor will it  
2 reduce actual or potential competition in any relevant market. To the contrary, the  
3 merger will enhance competition and, as I further explain in Section V, further benefit  
4 consumers in Washington through the greater efficiencies, scale, scope and  
5 complementary assets which the combined company will possess.

6 Recent events like Sprint and MCIWorldCom's announcement of the largest merger in  
7 U.S. history – and other such events over the past three years – only underscore this  
8 conclusion and further refute the arguments made by intervenors in this proceeding.  
9 Sprint and MCIWorldCom have justified their mega-merger on the grounds that the  
10 merger will provide the scale, scope, efficiencies and complementary assets *they* need to  
11 become “a dramatically more effective competitor” and to “lead the industry with  
12 innovative service offerings ... in an increasingly competitive global marketplace.”<sup>1</sup>  
13 This latest (and largest in terms of size) of almost countless proposed and completed  
14 telecommunications mergers is marketplace verification of what U S WEST and Qwest  
15 stated at the outset of this proceeding: that by combining skills, resources, reach and  
16 size they will be better able to meet customer needs in the bruising competitive  
17 telecommunications wars that are unfolding in Washington and worldwide. The  
18 proposed merger is therefore in the public interest, and I recommend that the  
19 Washington Utilities and Transportation Commission (“Commission”) approve the  
20 merger.

## **II. THE MERGER DOES NOT INCREASE THE LIKELIHOOD OF CIRCUMVENTING REGULATION**

1 **Please comment on the argument (Mitchell at 3, Goodfriend at 12) that the combined**  
2 **company will have the incentive *and* the ability to circumvent regulation.**

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<sup>1</sup> “MCI WorldCom and Sprint Create Pre-Eminent Global Communications Company for 21<sup>st</sup> Century,” Press Release, Oct. 5, 1999, at 1-2.

1 A. Dr. Mitchell states (at 3) that an incumbent local exchange carrier (“ILEC”) has two  
2 means by which it can “circumvent regulatory obstacles to its exploitation of monopoly  
3 power.” First, according to Dr. Mitchell, an ILEC can misinform regulators about its  
4 cost structure. Second, it can misinform regulators about the quality of its regulated  
5 services, thereby presumably saving the expenses and investments necessary to achieve  
6 high service quality levels. Similarly, citing four specific factors, Dr. Goodfriend (at 13-  
7 14) claims that “the information disadvantage experienced by regulators” will be  
8 exacerbated by the merger and, as a result, keeping “regulatory effectiveness” at its pre-  
9 merger level will become increasingly difficult and costly. As I discuss below, these  
10 concerns of Drs. Mitchell and Goodfriend are without merit. The proposed merger will  
11 increase neither the ability of nor the incentive for the merged company pursue the  
12 alleged strategies.

13 **Q. Is Dr. Mitchell correct (at 3) that “the asymmetry of information between regulators**  
14 **and regulated firms is a fact of life?”**

15 A. Dr. Mitchell is correct that a fundamental cost of the regulatory process is that information is  
16 not public and, thus, there will be information asymmetries between the regulator and  
17 the regulated firm. He is wrong, however, when he asserts that the merger will increase  
18 the magnitude of that problem to such an extent that this Commission will be unable to  
19 cope with it and will, therefore, be compelled to intervene in the marketplace and  
20 impose drastic solutions. Dr. Goodfriend is similarly wrong when she asserts (at 13-14)

1 that corporate reorganizations brought on by the merger will make it more difficult for  
2 competitors and regulators to detect violations of codes of conduct or existing regulatory  
3 prohibitions and, therefore, “[e]xpanded profit opportunities from regulatory  
4 circumvention also imply that economic penalties must be increased to counter the  
5 economic benefit of conscious violation.”

6 First, this Commission, like all regulatory agencies, has been coping with the problem  
7 of asymmetric information throughout its existence and has developed procedures,  
8 rules, and regulations to minimize the effect of that problem. It is simply not plausible  
9 to assert that the problem will be so much greater after the merger that current rules will  
10 be unable to cope adequately. U S WEST, like other public utilities in Washington,  
11 provides regulated and nonregulated services, and I understand that the Commission has  
12 time-tested procedures in place to deal with issues such as affiliated interest rules and  
13 rules for detecting cross subsidies. Imposing rules and regulations above and beyond  
14 those already in place will only increase costs unnecessarily (both to the firm and the  
15 Commission) while providing minimal added benefit.

16 Moreover, the argument that the merger will increase the size and scope of activities  
17 that are not regulated at the state level is fundamentally wrong. Size alone is irrelevant:  
18 the market capitalization of AT&T/TCI/MediaOne is roughly three times the  
19 capitalization of the merged firm. Increased scope is also irrelevant: Sprint-United is a  
20 vertically integrated combination of an ILEC and an inter-exchange carrier (“IXC”), yet

1 state regulators have no problem regulating the Sprint-United ILECs. In fact, before the  
2 divestiture of MediaOne and Continental Cable, this Commission regulated a  
3 U S WEST that was as large and provided as diverse a set of services as will the merged  
4 firm.

5 **Q. Dr. Mitchell argues (at 10) that the merger will increase U S WEST's incentive to**  
6 **divert resources in an effort to misinform regulators about its cost structure.**

7 **Please respond.**

8 A. By Dr. Mitchell's logic, *any* U S WEST venture into unregulated activities would have  
9 the same problem. But it is consistent with economic efficiency that U S WEST be able  
10 to diversify into other activities if it believes there are profitable opportunities. Both  
11 U S WEST and its customers are better off as a result. In fact, not only is it legally  
12 permissible for U S WEST to diversify into unregulated services—except for  
13 interLATA services before satisfying the Section 271 requirements of the  
14 Telecommunications Act of 1996 (“1996 Act”)—but it is actually encouraged to do so  
15 under the 1996 Act. The driving force behind telecommunications mergers is the  
16 imperative to achieve the economies of scale and scope that are necessary to be  
17 competitive. The same reason is propelling convergence throughout the industry where  
18 through the offering of combined local, long distance, wireless, high-speed internet  
19 access, and cable services, economies of scope are being maximized. Consider the  
20 following telecommunications mergers and acquisition announcements since the

1 passage of the 1996 Act, each of which was (or is) motivated by the need to achieve the  
2 economies of scale and scope necessary to become more competitive:

3	AT&T-MediaOne	AT&T-TCG	
4	AT&T-TCI	MCIWorldCom-Sprint	MCI-
5	WorldCom	WorldCom-MFS	
6	WorldCom-Brooks Fiber	MFS-UUNet	
7	Bell Atlantic-GTE	SBC-Ameritech	SBC-
8	PacTel	SBC-SNET	
9			

10 The purpose of the 1996 Act is to foster market entry, innovation, and diversification.  
11 Regulators have long expressed concern that the Regional Bell Operating Companies  
12 (“RBOCs”) have not been entering out-of-region interLATA markets. The proposed  
13 merger between U S WEST and Qwest addresses this concern. Such actions may be  
14 expected to encourage entry into out-of-region interLATA long-distance markets on the  
15 part of other RBOCs as well. Moreover, as long as price is above incremental cost,  
16 selling more unregulated services to consumers—such as Qwest long distance service in  
17 New York—will *lower* the amount of common costs that must be recovered from each  
18 individual customer, thus benefiting consumers of in-region regulated services as well.

19 In addition, diverting resources away from U S WEST’s regulated services can be a  
20 poor long-run strategy. The principal asset that Qwest is gaining access to is  
21 U S WEST’s region-wide base of 25 million customers of regulated services, and any  
22 diversion of attention or resources from those services will effectively squander the  
23 investment that Qwest is making.

**1 Dr. Mitchell states (at 13) that the likelihood of diverting resources is increased because**  
**2 Qwest is placing great importance on the opportunity to use U S WEST's financial**  
**3 resources after the merger. Do you agree with Dr. Mitchell's conclusion?**

4 A. No, I do not. Dr. Mitchell's argument rests on the notion that the merged company plans to  
5 finance new investment opportunities by reducing annual dividends on U S WEST's  
6 stock. Indeed, Dr. Mitchell places great significance (at 13-14) on the prospect that the  
7 merged company will stop paying a dividend. But, as a recent article in *The Economist*  
8 points out, fewer and fewer companies are paying dividends.<sup>2</sup> In the 1950s, nine out of  
9 ten companies paid dividends, but today only one in five do. Part of the reason for that  
10 is that companies are finding internal investment opportunities more profitable: "...  
11 even a company with profits should choose to retain them if it thinks that its own  
12 investment opportunities are better than those available to shareholders elsewhere."  
13 This description certainly characterizes dynamic industries such as telecommunications.  
14 The 1996 Act is intended to encourage, not discourage, this type of decision making.  
15 After the merger, the growth rate of the combined firm will likely be higher than that of  
16 U S WEST. As investors receive returns on their investments in the form of both  
17 capital gains and dividends, all else equal, one would expect a higher-growth firm to pay  
18 lower dividends.

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<sup>2</sup> "Shares Without the Other Bit," *The Economist*, November 20-26, 1999.

1 In any event, the dividend policy of a regulated firm is no more the proper concern of  
2 the regulator than is the use to which the stockholder puts the dividend check he or she  
3 receives. The earnings of the firm belong to the stockholders. While the Commission  
4 regulates the total amount of those earnings, the proportion of earnings that is paid out  
5 in dividends is entirely the prerogative of the regulated firm. A possible change in the  
6 dividend policy of the merged firm is irrelevant for gauging the effect of the merger on  
7 telecommunications customers in the state of Washington.

8 **Q. Dr. Mitchell (at 7) uses an FCC report to emphasize what he terms “very substantial**  
9 **deficiencies in [U S WEST’s] quality of service.” Is that a correct characterization**  
10 **of the content of the report?**

11 A. No. The report presents other statistics that indicate just the opposite. For example, from  
12 1997 to 1998, U S WEST’s average repair interval (hours) for switched access services  
13 decreased by more than 37 percent, revealing a commitment to service quality  
14 improvement. U S WEST also met a consistently high percentage of installation  
15 commitments for both residential and business customers. In many cases, U S WEST’s  
16 performance was on par with and, in some instances, better than the performance of  
17 other companies in the report.

18 The results of the Customer Perception Survey cited in the FCC’s report also reveal that  
19 U S WEST has improved its service to residential and small business customers.

1 U S WEST's percentage of dissatisfied customers is, in general, lower compared to  
2 those of the other companies in the report. In more than one instance, the percentage of  
3 dissatisfied U S WEST customers is half of that of Bell Atlantic or BellSouth. Overall,  
4 these tables do not indicate that U S WEST is offering service of a lower quality than  
5 other companies offering similar types of service.

6 These statistics also do not control for the characteristics of the territories served by  
7 U S WEST and other ILECs. Maintaining service quality in sparsely inhabited territory  
8 is more difficult and expensive than in urban, dense markets, and the report cited does  
9 not take such factors into consideration.

10 Finally, while service quality is undoubtedly a legitimate regulatory concern, Dr.  
11 Mitchell provides no evidence that the merger is likely to degrade service quality  
12 further.<sup>3</sup> To the contrary, the merged firm will have an increased incentive to improve  
13 service quality. To do otherwise will waste the asset—U S WEST's 25 million  
14 customers—that Qwest is gaining access to, and degrading U S WEST's basic exchange  
15 network will prevent the merged firm from selling the advanced services that require a  
16 sound basic network platform. Moreover, the merger provides an opportunity to change  
17 management practices, facilitating the adoption of the best practices from each merging  
18 company.

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<sup>3</sup> Indeed, U S WEST has stated its intent to invest in improving service quality over the next several years: see "Sol Trujillo Commits U S WEST to Improved Service," News Release, October 25, 1999.

### **III. THE MERGER DOES NOT INCREASE THE LIKELIHOOD OF ANTI-COMPETITIVE BEHAVIOR**

**1 What types of anti-competitive behavior do the intervenors allege will result from the  
2 proposed merger?**

**3 A.** The intervenors raise familiar arguments purporting to show that the merger will  
**4** increase both the incentive and the ability of the merging parties to engage in various  
**5** forms of anti-competitive behavior. Their concerns are with price  
**6** discrimination—supposedly in the form of the ILEC effectively charging itself a lower  
**7** rate for carrier access than it charges its long distance competitors—and non-price  
**8** discrimination—supposedly achieved by the ILEC effectively raising the costs that  
**9** competitive local exchange carriers (“CLECs”) or IXCs incur to compete against it.  
**10** Witnesses for McLeodUSA and AT&T—Dr. Mitchell (at 15-18), Dr. Goodfriend (at  
**11** 13-16), and Mr. Ward (at 38-42), respectively—make the same tired arguments that  
**12** competitors have raised in previous merger litigation and that regulatory and antitrust  
**13** enforcement agencies have rejected: that the merger will increase the likelihood of price  
**14** and non-price discrimination.

**15** I disagree and show below that the merger will provide neither the incentive nor the  
**16** ability for U S WEST or Qwest to engage in anti-competitive behavior. In particular,  
**17** the merger will not provide the merged company any incentive or ability to forestall  
**18** local exchange competition or distort competition in the long distance market.

1 Competitors' claims that the merger would increase the merged company's incentive  
2 and ability to engage in price squeezes, cross-subsidization, or various acts of non-price  
3 discrimination have no foundation in economics or experience in telecommunications  
4 markets.

5 **Q. Has the U.S. Department of Justice reached any conclusion regarding the**  
6 **competitive effects of these arguments?**

7 A. Yes. As part of its responsibility under the Hart-Scott-Rodino Act, the Justice  
8 Department reviewed the filings from U S WEST and Qwest and determined not to take  
9 any additional action.

10 **Q. How do you know the Justice Department considered market conditions in**  
11 **Washington in reaching this conclusion?**

12 A. The Justice Department is required to determine whether the merger would violate  
13 federal antitrust laws, which apply throughout the United States, including in  
14 Washington. The law most relevant to mergers is Section 7 of the Clayton Act, which,  
15 as amended,<sup>4</sup> states that:

16 no person engaged in commerce...shall acquire directly or indirectly...another  
17 person engaged also in commerce or in any activity affecting commerce, where  
18 *in any line of commerce* or in any activity affecting commerce *in any section of*  
19 *the country*, the effect of such acquisition may be substantially to lessen

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1 <sup>4</sup> The Celler-Kefauver Act of 1950, 64 Stat. 1125, 15 U.S.C.A. §18 (1987) plugged a loophole regarding the  
2 acquisition of assets rather than stock, and Stat. 1154 1158 (1980) expanded §7 to include entities other than  
3 corporations engaged in commerce or in activities affecting commerce.

1 competition, or to tend to create a monopoly. [emphasis added]

2 Thus, when the Justice Department determines not to take any action, it has examined  
3 telecommunications market conditions in the relevant markets nationwide—including  
4 Washington and other states—and concluded that the effect of the merger is *not* to  
5 substantially lessen competition or to create a monopoly in any telecommunications  
6 market in Washington.

7 **Q. But, doesn't the Justice Department apply a different standard to the merger than**  
8 **the public interest standard used by the Commission in Washington?**

9 A. Yes. The Justice Department answers the narrow question of whether the merger will  
10 lessen competition or tend to create a monopoly. The Commission looks at these and  
11 other factors to assess the public interest. But, in determining whether anti-competitive  
12 effects are likely from the merger, the Commission and the Justice Department use (or  
13 should use) the same economic framework.

**A. The Merger Does Not Increase The Likelihood Of Price  
Discrimination.**

1 **Q. What arguments have competitors raised to suggest that the merger would**  
2 **increase the likelihood of price discrimination?**

3 A. AT&T asserts that because carrier access charges are set above forward-looking  
4 economic cost, a merged firm would be able to discriminate by effectively charging its  
5 long distance affiliate a lower price for access than it charges its competitors.

1 **Q. Mr. Ward (at 54) asserts that the merger increases the potential for more price**  
2 **squeezes because “Qwest has facilities in place that could allow the merged**  
3 **company to provide more long distance services.” Mr. Ward argues further (at**  
4 **54-55), that if Section 271 approval is obtained, and the company does not price**  
5 **access charges at cost, then it can capitalize on that revenue by lowering retail**  
6 **costs to the point that no one could compete in the long distance market. Do you**  
7 **agree with his analysis?**

8 A. No. For a merger to increase the likelihood of a price squeeze, there must be some  
9 incentive or ability to undertake such an action in the first place. AT&T argues that  
10 ILECs have an incentive and the ability to engage in vertical price squeezes because  
11 their access services are priced above cost, and they (or their long distance affiliates)  
12 will not effectively pay those access prices. Rather, the amount by which the price of  
13 access exceeds its cost—the “contribution” from access—amounts to an intra-company  
14 transfer payment so that ILECs can profitably underprice AT&T’s retail services even if  
15 their costs are higher than AT&T’s (Ward at 54). These claims are wrong for two basic  
16 reasons.

17 *First*, the claim that an ILEC (such as U S WEST here) does not effectively pay access  
18 charges is nothing more than a familiar but elementary economic error. The ILEC entity  
19 as a whole is far from indifferent about the access contribution it receives from IXCs; on  
20 the contrary, loss of this contribution is a real cost to the firm that any prudent manager

1 would have to take into account. When AT&T carries the interLATA call, the ILEC  
2 receives the contribution from access. When the ILEC—or its affiliate—carries the call,  
3 the ILEC entity no longer receives the contribution from AT&T. While the payment  
4 from the ILEC affiliate to the ILEC for access is certainly a transfer payment, the  
5 absence of AT&T's contribution is a loss of real net income that occurs because the  
6 ILEC carries the call rather than an IXC. A prudent manager responsible for the ILEC's  
7 total profitability must include that *opportunity cost* of access contribution forgone as a  
8 *real and important cost* of providing retail long distance service. If, for example, the  
9 contribution from access were greater than the contribution from retail long distance  
10 service, total ILEC profits would fall every time the ILEC affiliate managed to win a  
11 new long distance account.

12 *Second*, basic economic theory shows why a price squeeze would be an unlikely event  
13 in the present circumstances. Assuming there are no alternatives to ILEC carrier access  
14 service, an interLATA price squeeze consists of pricing retail long distance service  
15 below the sum of the incremental cost of long distance service and the contribution from  
16 carrier access service.<sup>5</sup> In the short run, at least, a price squeeze thus reduces the ILEC's  
17 profits. To the firm, the economics of a price squeeze are the same as the economics of  
18 predatory pricing.<sup>6</sup> A price squeeze can only be profitable if, by undertaking it, the

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1 <sup>5</sup> At any price above this level, an IXC can purchase access from the ILEC and if its non-access costs are no greater  
2 than the non-access costs of the ILEC, the IXC can profitably compete against the ILEC's retail price.

1 <sup>6</sup> While it is true that one can afford to make less money on each transaction for much longer than one can lose money

(continued...)

1 ILEC can (i) drive its interLATA competitors from the market and (ii) erect sufficient  
2 barriers to entry so that competitors will not be able to re-enter the market when it  
3 attempts to raise its retail interLATA prices to recoup its lost profits.

4 Both elements of that scenario are unlikely in interLATA long distance markets, despite  
5 Mr. Ward's argument (at 54-55) to the contrary. AT&T, Sprint, and MCI-WorldCom  
6 (Sprint's merger partner) are large, global companies with deep pockets which have  
7 sunk ubiquitous facilities (switches and optical fiber transport) throughout the country.  
8 InterLATA long distance traffic in U S WEST's territory amounts to only about 12  
9 percent of the nation's total, and, as the FCC has recognized,<sup>7</sup> regional anti-competitive  
10 pricing could not reduce IXC profits sufficiently to drive them from the long distance  
11 market. IXCs use their facilities to supply services other than in-region retail switched  
12 long distance service<sup>8</sup> and, even if a price squeeze in switched long distance (based on  
13 control of switched access services) were to drive the IXCs out of that market, they and  
14 their facilities would remain in place, preventing the ILEC from raising long distance

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(...continued)

1 on each transaction, there is no point in even making less money on each transaction unless doing so  
2 accomplishes another objective: in this case, driving a rival from the market. But unless the ILEC has some  
3 prospect of eventually raising prices, it cannot recoup the profits it has invested in its rival's destruction, and  
4 the entire exercise has been a waste of stockholder's money.

1 <sup>7</sup> *Notice of Proposed Rulemaking*, FCC 96-308, released July 18, 1996, ("Non-Discrimination Safeguards NPRM"), at  
2 ¶137. "At least three interexchange carriers—AT&T, MCI, and Sprint—have nationwide or near-nationwide  
3 facilities. These are large well-established companies with customers throughout the nation. It may be  
4 unlikely, therefore, that a BOC affiliate, whose customers presumably would be concentrated in one  
5 geographic region, could drive one or more of these companies from the market."

1 <sup>8</sup> For example, private network services for large business customers and termination of interLATA calls from other  
2 regions.

1 prices to recoup its losses.<sup>9</sup>

2 **Q. Are there any additional reasons why AT&T's fears about a price squeeze are**  
3 **unfounded?**

4 A. Yes. *First*, as a practical matter, U S WEST's requirement to offer all of its retail  
5 telecommunications services to its competitors at a wholesale discount essentially  
6 precludes its ability to exercise any potential abuse of market power. If efficient  
7 competitors cannot compete because U S WEST's retail price is too low relative to the  
8 price of its essential facilities, they can always compete as resellers.

9 *Second*, ignoring resale, a price squeeze still does not make economic sense because, as  
10 I illustrated above, a price squeeze reduces profits. Such a strategy could only be  
11 profitable

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1 <sup>9</sup> Non-Discrimination Safeguards NPRM at ¶137. "Even in the unlikely event that [a BOC affiliate] could drive one  
2 of the three large interexchange carriers into bankruptcy, the fiber-optic transmission capacity of that carrier  
3 would remain intact, ready for another firm to buy the capacity at a distress sale and immediately undercut  
4 the [affiliate's] noncompetitive prices."

1 if U S WEST could expect to drive its competitors from the market and later raise prices  
2 (without attracting entry) to recoup its lost profits. That strategy makes no sense in the  
3 telecommunications markets in Washington where barriers to entry are low and  
4 established competitors with deep pockets supply long distance service in national and  
5 global markets.

6 *Third*, the simple assumption (inherent in AT&T's argument) that IXC's must purchase  
7 ILEC switched access services for all of their traffic is simply wrong. This is  
8 particularly true for the two largest IXC's (AT&T and MCI-WorldCom-Sprint) which  
9 own what formerly were the nation's two largest Competitive Access Providers  
10 ("CAPs"), TCG and MFS (in addition to MCI-WorldCom's ownership of Brooks  
11 Fiber). Practically since divestiture, IXC's have been using dedicated access  
12 facilities—self-supplied or purchased from CAPs or from the ILEC's' special access  
13 tariffs—to serve their high-volume customers and to bypass ILEC access facilities, and  
14 such access competition from CLEC's is accelerating and proliferating today. There are  
15 currently more CLEC's than ILEC's in the U.S.<sup>10</sup> and, as early as the first quarter of 1998,  
16 CLEC's began adding more business access lines than all of the RBOC's combined.<sup>11</sup>

17 The competitive position reached in two years by the CLEC industry took MCI over ten

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1 <sup>10</sup> 1,429 CLEC's holding 2,844 competitive local exchange certificates compared with 1,332 ILEC's, according to the  
2 *State Telephone Regulation Report*, Vol. 16, No. 19, September 18, 1998 at 1.

1 <sup>11</sup> Salomon Smith Barney Report, "CLEC's Surpass Bells in Net Business Line Additions for First Time," May 6, 1998.  
2

1 years to achieve after long distance markets were opened to competition.<sup>12</sup> The current  
2 consolidation among and between the largest IXC and CAPs also ensures that IXCs  
3 can self-supply carrier access service to many customers without dependence on ILEC  
4 access services. For example, analysts expect WorldCom—through its previous  
5 acquisitions of MFS and Brooks Fiber—to provide MCI with more than 70 percent of  
6 its access capacity, and AT&T, through its purchase of TCG, is expected to avoid a  
7 significant portion of ILEC access services.<sup>13</sup>

**B. The Merger Does Not Increase The Likelihood Of Non-Price  
Discrimination.**

1 **Q. What arguments have competitors raised regarding the effects of the merger on**  
2 **the likelihood of non-price anti-competitive behavior?**

3 A. Dr. Mitchell asserts that ILECs have the incentive and the ability to raise their  
4 competitors' costs by degrading the quality of service they provide their competitors and  
5 that the proposed merger would only encourage such behavior by increasing the merged  
6 company's incentive to divert resources.

7 These allegations—and the reasoning behind them—should be equally applicable to  
8 other mergers as well, including those that have already been concluded. The fact that  
9 the Department of Justice has never found such allegations compelling enough to justify

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1 <sup>12</sup> *Id.*

1 <sup>13</sup> Salomon Smith Barney, "WorldCom, Inc. Company Report," April 9, 1998 and Prudential Securities, "AT&T  
2 Company Update," January 21, 1998.

1 blocking mergers—in the case of both the proposed U S WEST/Qwest merger and the  
2 BA/GTE and SBC/Ameritech mergers already concluded—is again an important  
3 indication that the allegations lack merit.

4 **Q. Dr. Mitchell (at 15) states that the merger would increase the incentive of**  
5 **U S WEST/Qwest to degrade the quality of access to competing IXCs. Do you**  
6 **agree?**

7 A. No. There is no economic basis for this conclusion, and there are several reasons why it  
8 is unlikely to occur. *First*, and fundamentally, Dr. Mitchell does not explain how such  
9 non-price discrimination can be *effective enough to retain retail customers* and yet  
10 remain *indiscernible to competitors, regulators, or courts*. IXCs and CLECs have a  
11 strong interest—backed up with technically powerful tools—to detect network troubles,  
12 and they have every incentive to bring problems to the attention of the ILEC, the  
13 regulator, or the court.  
14 *Second*, setting aside legal and regulatory sanctions, such non-price discrimination is  
15 likely to backfire as a competitive strategy. The ILEC risks driving its largest  
16 customers—AT&T-TCG-TCI and MCI-WorldCom-MFS-Brooks Fiber-Sprint—to seek  
17 other alternatives for exchange access services. Because IXCs have alternatives to  
18 ILEC switched access service—particularly for serving high-volume  
19 customers—avoiding or resolving complaints from these high-volume customers is  
20 obviously a serious priority that U S WEST pursues in its own self-interest.

1        *Third*, indications are that, if granted Section 271 relief, ILECs could secure 25-30  
2        percent of long-distance traffic within their regions inside five years.<sup>14</sup> It is unlikely that  
3        U S WEST would risk delaying entry into the interLATA market by discriminating  
4        against its

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1    <sup>14</sup> Brigitte Greenburg, "Bell Atlantic Gets Long Distance OK: FCC Approval Makes Bell Atlantic First Regional  
2        Telephone Company to Offer Long Distance Service," December 22, 1999, Associated Press.

1 downstream rivals. It is considerably more plausible to believe that U S WEST would  
2 use this merger as an opportunity to demonstrate to state and federal regulators and, as  
3 well, to the Department of Justice, that it can safely be allowed to enter the interLATA  
4 market. In fact, the amount of revenue received by U S WEST for terminating Qwest's  
5 long distance calls from outside U S WEST territory is quite small. In 1999, Qwest  
6 accounted for between 3 and 4 percent of long-distance revenues nationwide. If Qwest  
7 buys that share of terminating access in U S WEST's territory, that translates into  
8 revenues of about \$45-60 million for U S WEST, or about 0.34-0.45 percent of  
9 U S WEST's total revenues or 1.15-1.54 percent of Qwest's. Presumably, these  
10 revenues could increase if U S WEST were to degrade the quality of terminating access  
11 it provides to competing long distance carriers. However, even if U S WEST were  
12 capable of such discrimination without, at the same time, attracting strong regulatory  
13 scrutiny—which it is not—the amount of revenue at stake would be small in  
14 comparison to the gains from entering the interLATA market.

15 *Fourth*, the ILEC would have to find discrimination to be an optimal strategy despite the  
16 onerous penalties for such behavior, e.g., the provision in §271(d)(6) of the 1996 Act  
17 which specifies that “[i]f at any time after the approval of an application under  
18 [§271(d)], the Commission determines that a Bell operating company has ceased to  
19 meet any of the conditions required for such approval, the Commission may ... suspend  
20 or revoke such approval.”

1 *Fifth*, and finally, it is incorrect for Dr. Mitchell to claim that there will be an  
2 unambiguous incentive for the merged entity to discriminate merely because  
3 discrimination would benefit a particular division of the company. A necessary  
4 condition for a firm to have an incentive to discriminate is that such discrimination  
5 prove profitable for the business entity *as a whole*. In fact, the economic literature  
6 confirms that the incentive to discriminate against competitors is not unequivocal.<sup>15</sup>  
7 Within the framework of formal oligopoly models, the incentive to discriminate often  
8 disappears when the ILEC is less efficient than its independent rivals downstream.  
9 Ironically, if U S WEST is as inept a competitor as Dr. Mitchell suggests, the incentive  
10 to discriminate may very well not arise in telecommunications markets in Washington.  
11 Dr. Mitchell's own client, McLeodUSA, has been operating very successfully in  
12 U S WEST's territory (outside the state of Washington) and discriminatory practices, if  
13 any exist, have done little to curb its growth. Indeed, McLeodUSA's own financial  
14 statements claim an 88 percent growth in access lines, a five-fold increase in earnings,  
15 and 14 straight quarters in which McLeodUSA has met or exceeded its CEO's  
16 expectations.<sup>16</sup>

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1 <sup>15</sup> If it is more profitable for U S WEST to sell carrier access services to competing IXCs than to provide toll service  
2 itself, it will have no incentive to discriminate against IXCs to increase its long distance market share. See  
3 D. Mandy, "Killing The Goose That May Have Laid The Golden Egg: Only The Data Knows Whether  
4 Sabotage Pays." *Journal of Regulatory Economics*, 2000 (Forthcoming). D. Weisman and J. Kang "Incentives  
5 For Discrimination When Upstream Monopolists Participate In Downstream Markets." Kansas State  
6 University Working Paper, December 1999.

1 <sup>16</sup> "McLeodUSA Posts Record Third Quarter," Press Release, October 27, 1999.

1 **Q. Dr. Mitchell asserts (at 17) that in-region customers will also be harmed if the ILEC**  
2 **degrades the quality of carrier access service. Do you agree?**

3 A. No. Dr. Mitchell's argument is that if an ILEC degrades the quality of access it provides its  
4 competitors, then it must also ensure that its own customers do not defect to other  
5 CLECs that maintain a higher quality of access. Dr. Mitchell suggests that the ILEC  
6 could do so quite cheaply by simply degrading the quality of its interconnection with  
7 other CLECs. However, again setting aside legal and regulatory sanctions (as discussed  
8 above), if U S WEST is as inefficient as Dr. Mitchell intimates, entry by nimble and  
9 innovative CLECs could, if anything, become a *profitable* opportunity for U S WEST,  
10 provided that its prices for interconnection and UNEs were compensatory. The  
11 incentive to discriminate need not arise in equilibrium if the vertically integrated firm is  
12 relatively inefficient and input prices command a positive margin. Suppose that new  
13 entrants introduce truly "new and innovative" service offerings. Under these conditions,  
14 I would expect the cross-elasticity between the ILEC's and CLEC's downstream  
15 services to be relatively small, and therefore the gains due to discrimination will be  
16 relatively low.

17 Because the merger of U S WEST and Qwest is of a vertical, rather than a horizontal,  
18 nature, the size of the in-region customer group will not be changed by the merger *per*  
19 *se*. In that situation, the merged company can have no incentive to degrade the quality  
20 of *terminating* carrier access—generally considered a bottleneck service provided by an

1 ILEC. The merged company can receive no strategic benefit from degrading the quality  
2 of terminating access because the IXC only receives revenue from the originating long  
3 distance caller, not the called party on the terminating end. Therefore, degrading the  
4 quality of terminating access will neither reduce the IXC's revenue from carrying the  
5 long distance call nor prompt any defection by the in-region customer to another  
6 CLEC.<sup>17</sup> The in-region customer's choice of a long distance carrier is unlikely to be  
7 affected by any degradation of the quality of terminating carrier access.

8 **Q. Dr. Goodfriend too (at 13-15) raises the specter of the vertical merger between**  
9 **U S WEST and Qwest creating an incentive and ability for the merged company to**  
10 **discriminate against its competitors. Is there any merit to her concerns?**

11 A. No. Dr. Goodfriend (at 13) states:

12 ... the expansion and marriage of in-state regulated operations with extensive  
13 complimentary [sic] (and possibly substitute) processes should raise concerns  
14 about an increased ability and incentive for the regulated ILEC to circumvent  
15 regulatory requirements for costing, pricing, unbundling, interconnection and  
16 service delivery in ways that benefit newly-affiliated operations.

17 Later on (at 15), Dr. Goodfriend claims again that "significant product and operational  
18 interrelationships, i.e., compliments [sic] and substitutes exist" between the merging  
19 companies. Dr. Goodfriend provides no evidence of the alleged substitutes, although it  
20 is obvious that complementarities between U S WEST and Qwest's lineup of

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1 <sup>17</sup> Any degradation of quality on the originating end (where the IXC *does* receive revenue from the originating long  
2 distance caller) does not adversely affect the terminating party's carrier choice either. That is because the  
3 terminating customer generally has no control over which IXC the originating customer will use to place the  
4 long distance call.

1 services—and the cost synergies available therefrom—motivated the proposed merger.

2 Nor does Dr. Goodfriend elaborate on what complementary (and possibly substitute)

3 *processes*—as opposed to products and services— might result. Her insinuation is that

4 *any* vertical merger is likely to be suspect because it creates incentives—and the

5 ability—to discriminate is. As a matter of economic logic, this is incorrect. It is well

6 known that the most common benefit of vertical mergers is that they produce “the

7 efficient organizational form.”<sup>18</sup> I discuss this benefit in greater detail later.

8 Dr. Goodfriend (at 15-16) prefers to see something more sinister in that new

9 organizational form. She apparently believes a post-merger reorganization will allow

10 the merged company to avoid full compliance with Section 271 of the 1996 Act, and all

11 the while make the Commission’s task of effectively regulating the merged company

12 more complex and arduous than before. Dr. Goodfriend’s testimony in this area is

13 confusing. While she recognizes the benefits from a merger when cost

14 complementarities exist, she apparently believes that the reorganization and realignment

15 of management functions needed within the merged company in order to secure those

16 very cost savings are somehow—and inherently—suspect and aimed at confounding

17 regulators. Her premise, however, is clearly far-fetched in light of the strong incentive

18 that U S WEST and Qwest have to emerge as an effective competitor, both within the

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1 <sup>18</sup> W. Kip Viscusi, John M. Vernon, and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust*, 2<sup>nd</sup> edition,  
2 Cambridge, MA: The MIT Press, 1996, at 225.

1 U S WEST region and outside, to the already operating lineup of formidable national  
2 integrated service providers.

3 Economic theory suggests that potential abuses stemming from vertical mergers, such as  
4 vertical foreclosure and price squeeze, cannot arise when effective competition exists  
5 (or, equivalently, market power does not exist) at one or more levels within the merged  
6 company.<sup>19</sup> In addition, those abuses can be prevented by appropriate safeguards such  
7 as those imposed by Sections 251, 252, 271, and 272 of the 1996 Act and others that the  
8 Commission already has in place. Until such time that the merged company secures  
9 Section 271 approval, Qwest is even divesting itself of its long distance service.

10 Therefore, there is no real cause for the kinds of concern that Dr. Goodfriend raises in  
11 her testimony.

#### **IV. THE MERGER WILL NOT REDUCE ACTUAL OR POTENTIAL COMPETITION**

1 **In his direct testimony, Dr. Mitchell (at 21-27) discusses the diminution of actual or**  
2 **potential competition. In order to put these arguments in the proper perspective, can**  
3 **you explain how an economist evaluates the effects of a merger on actual or potential**  
4 **competition?**

5 A. Certainly. Dr. Mitchell's factual description of the effect of the merger on competition

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1 <sup>19</sup> *Id.*, at 235.

1 in various markets can only be properly analyzed within a perspective provided by basic  
2 economic theory. Let me first explain that perspective.

3 Mergers between firms that compete in an identified “market” reduce the number of  
4 independent competitors and replace two smaller firms with one larger firm. Of course,  
5 mergers between firms that do *not* compete in any identified “market” do *not* reduce the  
6 number of actual competitors and, thus, pose no threat to *actual* competition in that  
7 market. In that case, the focus of the analysis changes to whether the merger will  
8 adversely affect “potential” competition, a matter I discuss in greater detail below. In  
9 either case—analysis of “actual” competition or “potential” competition—the relevant  
10 economic question for competitive analysis and public policy is whether, on balance, the  
11 potential cost savings from the economies of scale or scope brought about by the merger  
12 outweigh any potential competitive harm from the reduction in the number of  
13 competitors. If the competitive effects of the merger are benign, or if the efficiency  
14 gains likely to be realized outweigh any competitive harms, then telecommunications  
15 customers will clearly benefit from the merger through lower prices, higher quality, and  
16 more rapid supply of new services.

17 As I explain in greater detail in Section V, in analyzing the “benefit” side of this merger  
18 equation, economists examine several interrelated areas. Because mergers of the sort at  
19 issue here (as with the Sprint/MCIWorldCom merger) typically are voluntary  
20 transactions between the parties, each of which is led by experienced executives, the

1 firms' managements undoubtedly believe that their stockholders and customers will  
2 benefit from the merger. These benefits include:

3 Economies of scale and scope may result because of the increased size of the merged  
4 firm, through synergies in operations and management, or from expansion in output  
5 since markets available to the merged firm are larger than those served by the firms  
6 separately;

7 more competitive prices, higher quality service, and increases in output may result from  
8 increased competitiveness in certain markets; and

9 new products and services may be developed in greater number and/or at greater speed  
10 because the return on product development may be higher in the merged firm due to  
11 improved incentives or scale economies.

12 In addition, current and prospective employees of the firm can benefit from the creation  
13 and preservation of jobs in the merged firm stemming from its improved competitive  
14 position in markets in which the individual firms would be ineffective competitors.

15 **Q. In terms of the other side of the merger analysis—the detrimental effects on**  
16 **competition—how do economists appraise the effect of a merger on *actual***  
17 **competition?**

18 A. The economic framework used to evaluate the competitive effects of a merger is  
19 outlined in the *Merger Guidelines* issued by the U.S. Department of Justice and the  
20 Federal Trade Commission, which are used routinely by those agencies to assess the  
21 welfare effects of proposed mergers. Under the *Merger Guidelines*, the economic  
22 analysis of a merger begins by identifying the relevant product and geographic

1 “markets” in which the merging parties currently participate. Within those markets, the  
2 analysis then measures the effect of the merger on market structure—the number and  
3 size distribution of firms competing in a market—as an indicator of the likely effect of  
4 the merger on competition in those markets. To this end, the *Merger Guidelines*  
5 consider both the current level of concentration and the *change* in market concentration  
6 resulting from the planned merger.<sup>20</sup>

7 As a matter of fact, there is no appreciable *actual* competition between U S WEST and  
8 Qwest in the local exchange, long distance, or high-speed data markets in Washington  
9 in the following sense: Qwest is “small” in the markets in which it participates and has  
10 no unique advantages compared with other actual or potential entrants. Thus, there can  
11 be no issue in this proceeding that the proposed merger would significantly change  
12 actual market concentration in these markets in Washington, or that removing  
13 U S WEST and Qwest as independent competitors would affect market outcomes.

14 **Q. Please explain how economists appraise the impact of a merger on *potential***

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1 <sup>20</sup> Quantitatively, the *Merger Guidelines* divide markets into three categories based on the Herfindahl-Hirschman Index  
2 (“HHI”), which measures the sum of squared market shares of all firms in the market. Markets having a post-  
3 merger HHI below 1,000 are treated as unconcentrated, and mergers in such markets are thought to be  
4 sufficiently unlikely to have adverse competitive effects that the enforcement agencies generally perform no  
5 further analysis. Markets having an HHI between 1,000 and 1,800 are treated as moderately concentrated,  
6 and a merger that increases the HHI more than 100 points in a moderately concentrated market will generally  
7 trigger an examination of further factors. A post-merger HHI in excess of 1,800 represents a concentrated  
8 market. Mergers in concentrated markets that raise the HHI by more than 50 points will generally trigger  
9 further investigation, and mergers in concentrated markets that raise the HHI by more than 100 points will  
10 simply be presumed to increase the ability to exercise market power and—the *Merger Guidelines*  
11 suggest—would normally be opposed by the agencies. In practice, however, post-merger HHI increases of  
12 100 or more points in concentrated markets are not consistently challenged.

**1 competition as opposed to actual competition?**

2 A. A separate form of competitive analysis is applied to potential competition, one which  
3 assesses the degree to which the merger is likely to eliminate one of two sources of  
4 *potential* competition: (i) a “perceived potential” competitor whose perceived threat of  
5 entry (whether real or not) acts to discipline current prices in the market; or (ii) an  
6 “actual potential” competitor whose likely entry in the future (whether perceived or not  
7 by current competitors) would reduce future market concentration and help to control  
8 future price increases in the market. The effects of potential competition are necessarily  
9 more speculative than those of actual competition; consequently, pure potential  
10 competition cases are relatively rare.

11 **Q. Dr. Mitchell asserts (at 21-23) that the merger may have an anti-competitive effect**  
12 **by eliminating Qwest as a potential entrant into U S WEST’s local exchange**  
13 **markets in Washington. Do you agree?**

14 A. No. The merger is fundamentally a vertical merger, i.e., between suppliers of  
15 complementary rather than substitute products, and the arguments raised by intervenors  
16 in horizontal ILEC merger cases do not apply here. Moreover, the “potential  
17 competition” argument utterly fails on the merits. In assessing the number and  
18 sufficiency of potential competitors, the Commission must distinguish between a  
19 *potential* competitor and an *actual* competitor. It is wrong to treat even *likely* potential

1 competitors as if they have already entered the market and, therefore, the merger is  
2 entirely horizontal between actual, current competitors. Removing a potential  
3 competitor from the market through merger has less of an effect on prices and output  
4 than does removing an existing or actual competitor. This is true, *first*, because there  
5 are several layers of uncertainty and speculation surrounding any analysis that concludes  
6 that removal of a potential competitor is competitively significant. At best, the effect on  
7 competition of the loss of a potential competitor can only be determined conditionally  
8 and based on a number of assumptions and guesses about the future: (i) whether the firm  
9 would have entered at all, (ii) when, and at what scale it would have entered, (iii) what  
10 other firms would have entered in the same time frame, and (iv) what unique attributes  
11 (if any) the potential competitor would bring to bear on the market and, thus, to prices  
12 and service quality. Arrayed against these hypotheticals are the relative certainties of  
13 lower costs and prices and higher service quality that result from the economies of scale  
14 and scope engendered by the merger.

15 *Second*, a firm that is actually competing in the market should be regarded seriously as a  
16 more effective competitor than an otherwise identical potential entrant. In contrast with  
17 a mere potential entrant, the presence of an actual competitor in a market shows that (i)  
18 that firm has overcome any and all barriers to entry and (ii) signaled by its investment  
19 commitments its intention to stay in that market. In general, the benefit from an actual  
20 market presence should count for more than any possible benefit from a potential future

1 market presence. Competition by firms already in the market is presumptively  
2 beneficial because those firms have already passed a market test; potential competition  
3 by firms that have not yet entered a market carries no such presumption.

4 This conclusion is further reinforced here by the fact that the blocking of a proposed  
5 merger is particularly shaky on public policy grounds when (i) the market in question is  
6 rapidly growing and dynamic in terms of new technology, new entry, and globalization,  
7 and (ii) the merged company's service prices—both to its own customers and to its  
8 competitors—are subject to regulatory control. A merger of potential competitors in  
9 such a dynamic market does not necessarily reduce the effective number of competitors  
10 in the long run because entry is rapid as demand grows and technology changes.

11 Similarly, a reduction in the number of potential competitors in such a market does not  
12 affect prices and quantities in the same way that it might in a mature, unregulated  
13 market not experiencing rapid growth.

14 **Dr. Mitchell states (at 21) that the relevant questions for assessing potential competition**

15 **are: (i) “would Qwest be likely to enter the local exchange market if the merger**  
16 **does not go through?” and (ii) “does the merger negatively affect the probability**  
17 **that some other firms would enter the market or the timeliness of their entry?”**

18 **Are these the relevant questions?**

19 A. Only partly. Dr. Mitchell ignores an important element of the Department of Justice's and

1 the *Merger Guidelines*' analyses of the effects of a merger on *potential* competition,  
2 namely, the relative *significance* or competitive impact through the merger of  
3 eliminating one "potential competitor" as opposed to all the *other* potential entrants in a  
4 market. Suppose a particular new firm has a choice between entering the market as a  
5 potential competitor to an existing firm or by merging with that firm. The question then  
6 is: is the latter form of entry (by merger) likely to be better or worse for the state of  
7 competition in the market than the former form of entry (as a potential competitor)?  
8 The answer depends on what *other* potential competitors in that market are able to do.  
9 If those other potential entrants can exert the same competitive discipline on the  
10 market—to the same degree *and* at the same time—as could the single potential  
11 competitor that enters through merger rather than on its own, then the elimination of  
12 that single potential competitor because of the merger should, in theory, have no  
13 competitive significance. Dr. Mitchell's analysis does not take proper account of the  
14 pricing discipline that occurs when competitors can enter a market and provide service  
15 quickly.

16 As the *Merger Guidelines* make clear, there does not need to be more than a few other  
17 such competitors, nor do they have to actually be operating in a market today in order to  
18 compensate for the loss of the merging firm as a potential competitor. Although the  
19 potential competition doctrine does not appear in the current version of the *Merger*  
20 *Guidelines*, the 1984 version of the *Merger Guidelines* noted that "[t]he Department [of

1 Justice] is unlikely to challenge a potential competition merger if the entry advantage  
2 ascribed to the acquiring firm (or another advantage of comparable importance) is also  
3 possessed by three or more other firms.”<sup>21</sup> In terms of the timeliness of entry, the  
4 *Merger Guidelines* state that:  
5 [t]he Agency generally will consider timely only those committed entry  
6 alternatives that can be achieved within two years from initial planning to  
7 significant market impact..<sup>22</sup>  
8 I conclude, based on these principles as well as an application of the *Merger Guidelines*  
9 to the facts here, that the alleged elimination of Qwest as a potential entrant into  
10 U S WEST’s local exchange market will have no competitively significant effect.  
11 Numerous other firms are as well, if not better, positioned to enter the market to  
12 compete against U S WEST than is Qwest, and Qwest does not possess any particular  
13 advantage over the other potential or actual entrants. To the contrary, Qwest is actually  
14 at a disadvantage with respect to many other actual or potential entrants (such as the  
15 “Big Three” IXC, CAPs, CLECs, and cable companies) that already possess facilities,  
16 customers and brand name recognition. Thus, the merger poses no threat to actual or  
17 perceived potential competition in the local exchange or any other telecommunications  
18 markets in Washington.

19 **Dr. Mitchell states (at 23) that the merger may deter other firms from entering the market**

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1 21 1984 *Merger Guidelines*, 4.133. These policies regarding the effects on potential competition were, however,  
2 specifically cited as remaining in effect in the *Statement Accompanying Release of the Revised Merger*  
3 *Guidelines*, April 2, 1992, at 3.

1 22 *Merger Guidelines* at 51.

**1 if a “national identity” is an important competitive factor, and a U S WEST/Qwest  
2 merger captures this competitive factor. If this were to occur, would it be an  
3 undesirable outcome of the merger?**

4 A. Absolutely not. Dr. Mitchell is making an implausible assertion that, by imparting a  
5 national presence to the merged firm, the merger will deter some other firms from  
6 entering the market. Dr. Mitchell seems to be arguing for handicapping incumbents to  
7 make it easier for competitors to grow—an infant industry argument. Such a policy is  
8 disastrous and denies consumers the benefit of lower prices and new services. As  
9 mentioned earlier, other competitors (AT&T/MediaOne, MCIWorldCom/Sprint, and  
10 other ILECs) have a national presence, are not small, and are not in need of any  
11 protection. The merger may also result in lower costs and prices for U S WEST which  
12 will make it more difficult for CLECs to compete successfully with it. But that, in and  
13 of itself, is not a bad outcome. Customers always benefit from lower costs and lower  
14 prices; hence, any effort to prevent  
15 U S WEST from taking advantage of its lower costs (or national presence) in supplying  
16 services to customers would deny those customers the very benefits that competition  
17 was supposed to bring them.

**18 Q. Can the merger have an anti-competitive effect by eliminating Qwest as a potential  
19 entrant into the high-speed data market in Washington?**

1 A. No. Qwest is principally a provider of long distance services. Even though Qwest has  
2 been building a network, both within the U.S. and overseas, capable of providing  
3 advanced, high-speed data, and other high-bandwidth services (a fact evident from the  
4 testimonies of Dr. Mitchell and Mr. Davis for Qwest), its current network in  
5 *Washington* is relatively small, comprising a pair of fiber links between Seattle and  
6 Portland. There is no reason *a priori* to believe, therefore, that the merger will mean a  
7 loss of a major provider of high- speed data access in the state of Washington. By the  
8 same token, there is no reason to believe that the merged company will abandon pursuit  
9 of the market for high-speed data access services (or the set of services Dr. Blackmon  
10 refers to as “advanced services”). Indeed, both U S WEST and Qwest are well aware of  
11 the dangers of failing to do so. Formidable competitors in the form of  
12 AT&T/TCI/TCG/MediaOne, MCIWorldCom/Sprint (were the merger to be  
13 consummated), SBC/Ameritech, and Bell Atlantic/GTE are poised to provide all of  
14 these services over a variety of media. The AT&T combination, in particular, is well-  
15 positioned to use its considerable cable and wireless broadband assets to serve the state  
16 of Washington (and is presently providing local, long distance, cable, Internet, and other  
17 services on an integrated basis in the Seattle area).<sup>23</sup>

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1 <sup>23</sup> AT&T has lately been soliciting business from its “best customers” in the Seattle area, promising “local telephone  
2 service delivered over our upgraded network that’s already connected to your home!” AT&T offers to  
3 combine local, long distance, and data services with *free* phone connections and packs of ten features, and  
4 asks the customer to dial 1-800-PICK-ATT “to be plugged into AT&T’s state-of-the-art digital  
5 communications network.”

1 **Q. Dr. Blackmon (at 4) calls for creating “one or more separate affiliates [of the**  
2 **merged company] to provide all advanced services and Internet access services on**  
3 **a phased-in basis.” Is such separation necessary to prevent supposed anti-**  
4 **competitive behavior by the merged company?**

5 A. No. As I explained earlier, anti-competitive behavior in the post-merger era cannot  
6 happen if other actual or potential competitors can continue to exert competitive  
7 discipline despite the withdrawal of one potential competitor. From the business plans  
8 of the major merged entities cited in my answer to the previous question, it is obvious to  
9 me that the type of protection envisioned by Dr. Blackmon will be neither necessary nor  
10 wise. If anything, any action taken to hamstring the merged company (such as the  
11 separate affiliate requirement for advanced services) will prevent it from competing on  
12 the basis of *integrated* service offerings which all of its competitors will be able to  
13 provide. Even SBC/Ameritech will be able to include interstate long distance service in  
14 its service package because Washington is an out-of-state operation for it. Other  
15 competitors like AT&T have left no doubt that they will pursue every option for the  
16 purpose of providing “all-distance” services (including advanced services) to their  
17 customers.<sup>24</sup>

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1 <sup>24</sup> “AT&T Steers New Course,” *Telephony*, December 13, 1999, at 8.

**V. THE BENEFITS FROM THE U S WEST/QWEST MERGER ARE  
LIKELY TO BE SUBSTANTIAL**

**1 Dr. Mitchell (at 27-29) claims that the efficiencies and other advantages from the merger  
2 have not been shown. In fact, is there any evidence regarding the effect of  
3 telecommunications mergers on the ability of the participants to compete and better  
4 serve their customers?**

**5 A. Yes. It is a truism in telecommunications that combining complementary assets and  
6 skills in a single firm reduces its costs, increases its productivity, enhances its incentives  
7 to invest and, generally, improves its ability to compete. In its presentation to the  
8 investment community, MCIWorldCom noted that the “consumer benefits” from its  
9 merger with Sprint would stem from the merged company’s becoming an “aggressive,  
10 innovative competitor to AT&T/MBOCs with [a] full range of services,” and that  
11 “tremendous cost savings [from the merger will] drive pricing flexibility.”<sup>25</sup> In addition,  
12 the parties claimed that “additional scale enhances [MCI’s] industry leading cost  
13 structure,” and the merger “enables more innovation” and “drives value for  
14 customers.”<sup>26</sup> In a curious parallel to the costs savings estimated here and criticized by  
15 Dr. Mitchell, MCI WorldCom and Sprint also identified annual operational cost savings  
16 from their merger of approximately \$1.9 billion in 2001 (the first year after the merger)**

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<sup>1</sup> <sup>25</sup> MCI WorldCom-Sprint Merger Announcement, slide 11. See [http://www.wcom.com/about\\_the\\_company/  
investor\\_relations/presentations/sprint](http://www.wcom.com/about_the_company/investor_relations/presentations/sprint).

<sup>1</sup> <sup>26</sup> *Id.*, slide 26.

1 rising to \$3 billion by 2004.<sup>27</sup> Most telling is the statement that the merger provides  
2 “each company with the complementary assets needed to compete *in a market where*  
3 *scale is increasingly critical for survival.*”<sup>28</sup>

4 These statements are only the most recent recognition by competitors of U S WEST and  
5 Qwest that the ability to achieve scale, scope, and cost savings and to combine  
6 complementary assets are powerful and important reasons to pursue a merger. Even  
7 before announcing its plans to combine with MCIWorldCom, Sprint’s Chairman,  
8 William Esrey, was telling shareholders that “other companies [are] in a rush of  
9 acquisitions, trying to assemble what Sprint has already put in place”, and that  
10 companies such as U S WEST and Qwest were “merging and *marrying in an attempt to*  
11 *avoid being the marketplace or technological old maid.*”<sup>29</sup> Another example is provided  
12 by Sprint’s new marriage suitor. In describing their then-pending merger, MCI and  
13 WorldCom observed that

14 [i]n addition to the combination of MCI’s and WorldCom’s customer base,  
15 name recognition and local exchange networks, the merger will result in other  
16 competitive synergies and efficiencies.... The combined company will have a  
17 greater ability to sell a broader package of services...as well as state-of-the-art  
18 telecommunications services which WorldCom has developed.... With the cost  
19 savings and efficiencies the merger will bring, and the combined company’s  
20 financial strength, significant facilities-based competition has a real prospect of

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1 27 “MCI WorldCom and Sprint Create Pre-Eminent Global Communications Company for 21st Century,” press  
2 release, October 5, 1999. See [http://www.wcom.com/about\\_the\\_company/press\\_releases/  
3 display.phtml?cr/19991005](http://www.wcom.com/about_the_company/press_releases/display.phtml?cr/19991005).

1 28 MCI WorldCom-Sprint Merger Announcement (*supra* fn. 26), slide 20.

1 29 Sprint 1998 Annual Report at 2,4 (Letter from William T. Esrey, Chairman and CEO).

1 success.

2 The combined company will achieve significant cost savings and efficiencies  
3 and have greater financial strength and enhanced ability to raise capital...<sup>30</sup>

4 The exposure of local exchange markets to competition has had the effect of increasing  
5 local exchange carriers' incentives to become more efficient, and one aspect of that  
6 effect has been the movement towards consolidation among CLECs such as AT&T-  
7 TCG-TCI and MCI-WorldCom-Sprint-Brooks Fiber-MFS-UUNet, large ILECs such as  
8 Bell Atlantic-NYNEX-GTE, SBC-Ameritech-PacTel-SNET, and small ILECs such as  
9 ATU-PTI in Alaska or Aliant-Alltel in Nebraska. As AT&T noted in its 1998 *Annual*  
10 *Report*,

11 In 1998 AT&T Network Services focused on growing the existing network,  
12 enhancing its reliability and improving unit-cost effectiveness. "We're  
13 continuing those efforts in 1999," [AT&T Network Services President] Ianna  
14 says, "while at the same time realizing meaningful synergies from the TCG, TCI  
15 and IBM assets." (at 23)

16 When it announced its proposed acquisition of MediaOne a few months later, AT&T  
17 included as one of the benefits of that transaction that it could achieve between \$175  
18 and \$200 million in "Total Annual Synergies" as a result.<sup>31</sup> Because such consolidations  
19 reduce costs and expand the ability of the combined firm to compete, consumers are the  
20 ultimate beneficiaries, as Sprint and MCIWorldCom have repeatedly emphasized in

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1 <sup>30</sup> Joint Reply of WorldCom, Inc. and MCI Communications Corporation to Petition to Deny and Comments, CC  
2 Docket No. 97-211, January 26, 1998, at 9-11.

1 <sup>31</sup> Investment Community Briefing, "AT&T Proposal for MediaOne Acquisition", April 23, 1999, at 23.

1 recent days. Thus, MCIWorldCom’s CEO, Bernard Ebbers, wrote in the *Wall Street*  
2 *Journal* that “[t]he new WorldCom will benefit consumers by providing a stronger  
3 competitor to the Bells and AT&T.”<sup>32</sup>

4 Strategic mergers are a large part of the plans of U S WEST’s and Qwest’s competitors,  
5 and if regulation prevents these companies from keeping pace, customers in Washington  
6 will be left behind. For example, AT&T describes its competitive strategy in 1998 as  
7 follows:

8 We completed our \$11 billion merger with Teleport Communications Group,  
9 Inc. (TCG), giving us local network facilities to reach business customers in  
10 more than 80 U.S. markets. We gained broadband connections to one third of  
11 U.S. households through our merger with Tele-Communications Inc. (TCI),  
12 which closed in March 1999. We conceived a joint venture with British  
13 Telecommunications plc (BT) designed to build a 100-city, global IP network  
14 and become a leading carrier of global communications traffic. We agreed to  
15 acquire the global network business of IBM for \$5 billion. We continued the  
16 expansion of our national digital-wireless footprint, investing more than \$1  
17 billion in capital, assuming management control of our joint venture in Los  
18 Angeles and agreeing to acquire Vanguard Cellular Systems. And shortly into  
19 1999, we announced a joint venture with Time Warner, Inc., as well as joint  
20 ventures with five TCI affiliates that will extend our cable telephony footprint  
21 into more than 40 million homes. (*AT&T Annual Report* at 29).

22 The list of recent and on-going consolidations is staggering. Consider these recent  
23 acquisitions, each of which was premised on improving the strategic positions of the  
24 participants:

25 MCI WorldCom announced the largest corporate takeover ever when it announced its

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1 <sup>32</sup> B. Ebbers, “MCI-Sprint is No Big Deal,” *Wall Street Journal*, Oct. 8, 1999, at A18.

1 plans to merge with Sprint—a transaction valued at over \$100 billion.<sup>33</sup> The combined  
2 company will have a stock market value of \$200 billion or more, making it the biggest  
3 telecommunications company in the world when its wireless assets are included.<sup>34</sup>

4 Vodafone, a U.K. mobile operator, announced its purchase of Mannesmann, a  
5 German telecommunications firm, for approximately \$183 billion. This  
6 was the largest corporate takeover in history.<sup>35</sup>

7 Deutsche-Telekom and Telecom Italia announced they would combine  
8 vertically-integrated firms in different regions (much like BA and GTE)  
9 to form the world's largest communications company (\$210 billion  
10 capitalization),<sup>36</sup>

11 AT&T announced its intention to buy cable giant MediaOne for \$58 billion on  
12 April 22, 1999. AT&T Chairman C. Michael Armstrong stated:  
13 “Together, AT&T and MediaOne will bring broadband video, voice and  
14 data services to more communities, more quickly than we could  
15 separately or, in MediaOne's case, with any other company.”<sup>37</sup>

16 Global Crossing closed its merger with Frontier on September 28, 1999. Gary  
17 Winnick, Founder and Chairman of Global Crossing stated that “with our  
18 merger with Frontier, Global Crossing is well positioned to take its share  
19 of a global telecommunications market that will be worth \$1 trillion by  
20 2005.”<sup>38</sup>

21 Of course, the most compelling evidence regarding the efficiency gains associated with  
22 the U S WEST/Qwest merger is the fact that knowledgeable parties are willing to bet

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1 33 Thor Valdmanis and Paul Davidson, “Sprint Board Backs MCI Bid: Moves Are Mad Scramble in a Changing  
2 Industry,” *USA Today*, October 5, 1999.

1 34 “MCI WorldCom Confirms \$115 Billion Megadeal To Acquire Sprint,” *Dow Jones Business News*, October 5, 1999.

1 35 “Vodafone-Mannesmann Merger Seen Spurring Additional Worldwide Telecom Consolidation,”  
2 *Telecommunications Reports*, February 7, 2000.

1 36 “International Telecom Consolidation Quickens As Deutsche Telekom, Telecom Italia Agree To Merge,”  
2 *Telecommunications Reports*, April 26, 1999, at 7. On May 21, Olivetti secured 51 percent of Telecom Italia  
3 stock for \$33 billion, but reports on May 25 suggest that Olivetti may still pursue the merger with Deutsche  
4 Telekom: “D’Alema Says Olivetti May Consider Merger,” *International Herald Tribune*, Paris, May 25,  
5 1999. Subsequent events suggest the merger with Deutsche Telekom is unlikely in the near future.

1 37 “AT&T offers \$62 billion in cash, stock and assumed debt and preferred equity for MediaOne Group,”  
2 <http://www.att.com/press/item/0,1193,439,00.html>, May 6, 1999.

1 38 “Global Crossing Completes Merger with Frontier,” Frontier Press Release, September 28, 1999.

1 with their own money that the transaction will result in an increased value for the  
2 combined enterprise. Except in cases where a merger increases market  
3 power—reducing output and increasing price—the fact that combining firms increases  
4 profits means that economic efficiency has increased. Increases in economic efficiency  
5 make everyone—consumers and suppliers alike—better off, and fostering efficiency  
6 gains is one of the most important functions of government and regulation in our  
7 market-based economic system. The importance of achieving these efficiency gains is  
8 stressed in the *Merger Guidelines* that are used by the federal antitrust enforcement  
9 agencies to assess mergers:

10 “[t]he primary benefit of mergers to the economy is their efficiency-enhancing  
11 potential, which can increase the competitiveness of firms and result in lower  
12 prices to consumers.”<sup>39</sup>

13 **Dr. Mitchell (at 30) recommends that the Commission condition its approval of the**  
14 **proposed merger on various commitments by U S WEST. Do you believe such**  
15 **commitments are necessary to ensure that consumers benefit from the merger?**

16 A. No, I do not. I will leave the issue of what the company agrees to do with respect to  
17 these requests to the company’s representatives. However, from an economic  
18 perspective, I do not believe commitments of this type are necessary or productive here  
19 to ensure that consumers receive optimum value for their money. For example,

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<sup>1</sup> <sup>39</sup> *Merger Guidelines* Section 4, at 55.

1 U S WEST should be allowed to use the savings associated with the merger in the way  
2 customers demand. Market demand should—and will—determine where the combined  
3 company invests if it is to succeed in the coming years. Attempting to micro-manage a  
4 telecommunications company's business flies in the face of the competitive paradigm  
5 this Commission is striving to achieve.

6 The Commission does not need to condition approval of this merger on any additional  
7 requirements as proposed by Dr. Mitchell. The Commission will have the same  
8 regulatory oversight and authority of U S WEST's rates and practices after the merger is  
9 consummated as it does today.

10 **Q. Does this conclude your rebuttal testimony?**

11 **A. Yes.**