BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In re Application of GTE CORPORATION and BELL ATLANTIC CORPORATION	))	
	)	**DOCKET NO. UT-981367**
for an Order Disclaiming Jurisdiction or, in the Alternative, Approving the GTE CORPORATION – BELL ATLANTIC CORPORATION Merger	))))	
……………………………………………	)	

DIRECT TESTIMONY OF

STEPHEN B. LEVINSON

ON BEHALF OF

AT&T COMMUNICATIONS OF THE PACIFIC NORTHWEST, INC.

AUGUST 2, 1999

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1 **I. INTRODUCTION AND BACKGROUND**

2 **Q. PLEASE STATE YOUR NAME.**

3 A. I am Stephen B. Levinson.

4 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

5 A. I am a senior economist in the Law and Government Affairs Division at AT&T Corp.,
6 where I have worked for more than 23 years specializing in the economics of regulation
7 in the telecommunications industry.

8 **Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?**

9 A. I have a BA, MA and Ph.D., all in Economics, from Rutgers University.

10 **Q. WHAT IS YOUR WORK EXPERIENCE?**

11 A. In recent years, I have been engaged in developing and articulating the properties of Total
12 Service Long Run Incremental Cost applied to unbundled network elements, which
13 eventually came to be known as Total Element Long Run Incremental Cost, or TELRIC,
14 and in developing AT&T's policy position on the meaning of the public interest standard
15 under the Telecommunications Act of 1996. I have testified as an expert witness in state
16 proceedings on local exchange company pricing and costing issues in Colorado, Indiana,
17 Ohio, and Wyoming. I have filed an affidavit in the SBC-Ameritech merger case, CC
18 Docket No. 98-141, and in the BA-GTE case at the FCC, Docket No. 98-184. I also filed
19 testimony in the BA-GTE merger docket in Iowa, Docket No. SPU-98-9.

1 **II. PURPOSE AND SUMMARY**

2 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

3 A. The purpose of my testimony is to provide the Washington Utilities and Transportation
4 Commission ("Commission") a perspective on the anticompetitive aspects and potential
5 consumer harm of the pending merger between GTE Corporation ("GTE") and Bell
6 Atlantic Corporation ("Bell Atlantic"). While this proposal does not involve the merger
7 of two Washington companies, it does raise serious concerns regarding the potential for
8 competition in the GTE territory of the state and the potential for the customers currently
9 served by GTE to find themselves worse off as a result of the merger, due to reduced
10 service quality and investment in opening GTE's local markets to competition.

11 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

12 A. My testimony will evaluate the merits of the proposed merger between Bell Atlantic and
13 GTE. For a variety of reasons described below, I find that this merger raises significant
14 competitive concerns. Principal among these are, first, that the merger is likely to
15 increase the extant monopoly power enjoyed by Bell Atlantic and GTE and the incentives
16 for both companies to engage in actions to delay the emergence of effective competition
17 in the provision of local exchange services. Second, the merger eliminates a significant
18 potential entrant into both Bell Atlantic and GTE territories, as well as the territories of
19 other incumbent local exchange carriers ("ILECs"), including U S WEST's in
20 Washington. The demise of this prospective source of competition is especially critical

1 given the highly concentrated nature of local exchange telephony and the critical
2 importance of competition for the future performance of the telecommunications industry.
3 Third, the merger is distinctly counter to the pro-competitive, deregulatory goals of the
4 Telecommunications Act of 1996 ("Act" or "1996 Act") and Washington law favoring
5 competition in all telecommunications markets. The merger both heightens the need for
6 additional regulatory oversight and simultaneously erodes the effectiveness of such
7 regulation. The consequences of this merger, then, are likely to be less competition and
8 more (but less effective) regulation.

9 **III. IMPACT OF THE PROPOSED MERGER**

10 **Q. IS THIS MERGER ANTICOMPETITIVE?**

11 A. Yes. Bell Atlantic and GTE have argued ~~at the FCC~~ that this merger does not raise
12 competitive concerns because there is an "~~developing~~emerging national market" for~~a~~
13 ~~"bundled product"~~"packaged telecommunications services" offerings and that the
14 combined company will be only one of several firms competing in this market[1]. This
15 argument, however, fails to recognize that the pace at which competition grows in this
16 emerging market is critically dependent upon the behavior of the ILECs in providing
17 essential inputs to new entrants on non-discriminatory terms (including both price and
18 quality). Importantly, that behavior is affected adversely by combinations, such as this
19 one, that enhance the incentive and ability of these firms to adopt exclusionary practices

[1] McCallion Direct Testimony, pp. 13-14; McCarren Direct Testimony, p. 3.

1 that inhibit entry. Thus, the speculative market conditions that these companies use to

2 justify the merger are themselves made less likely to materialize if this acquisition is

3 consummated.

4 **Q. WHAT IS THE PRIMARY HARM TO COMPETITION OF THIS MERGER?**

5 A. The primary harm inflicted upon competition (and, therefore consumers) by the proposed

6 union of Bell Atlantic and GTE is that the merger also raises the barriers to entry into

7 both companies' local exchange markets by increasing the incentive and ability to engage

8 in exclusionary conduct. Thus, this merger displays serious anticompetitive

9 consequences that are not dependent upon the theory of potential competition. That

10 theory merely serves to exacerbate the other, more direct, anticompetitive effects that, on

11 their own, should serve to condemn the proposed merger.

12 **Q. WON'T THE MERGER OF BELL ATLANTIC AND GTE RESULT IN MORE**

13 **COMPETITION FOR THE LOCAL MARKET IN WASHINGTON?**

14 A. No. Any change resulting from this merger will likely be toward less open markets and

15 less local competition. Bell Atlantic, while it has the possibility of access to the

16 interLATA market in exchange for opening its local markets, has been no better at

17 promoting competition than any other RBOC. Furthermore, Bell Atlantic executives

18 have publicly stated their admiration for GTE's regulatory and litigation approach to

19 protecting its local monopoly[2]. There is no basis, therefore, to hope that this change in

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1 [2] BellAtlantic-GTE Press Conf. (July 28, 1998).

1 ownership will have any positive effect on local exchange competition in the GTE
2 territory for all the reasons stated above.

3 **IV. THE MERGER APPLICATION IN PERSPECTIVE**

4 **Q. HOW DOES THIS MERGER FIT IN THE CONTEXT OF COMPETITION IN**
5 **THE TELECOMMUNICATIONS MARKET?**

6 A. To evaluate the competitive impact of the proposed merger of Bell Atlantic and GTE, it is
7 important to understand both the lineage and current status of industry structure in the
8 provision of telephony in the United States. After a period of open rivalry in the first part
9 of the twentieth century, telephone service in the United States evolved into one of
10 monopoly supply. While affording stability and continuity, monopoly supply with
11 pervasive regulation exacted a heavy toll on consumer welfare. It is widely conceded
12 that, by denying entry and the proliferation of multiple carriers for individual customers,
13 public policy inadvertently caused a number of maladies including retarded rates of
14 innovation, reduced allocative efficiencies, suppressed consumer choice and widespread
15 cross-subsidization.

16 **Q. HOW DID COMPETITION FIRST DEVELOP IN THE LONG DISTANCE**
17 **MARKET?**

18 A. Beginning with MCI's entry into the long distance marketplace, various cracks began to
19 develop in the monopoly provision of telephony. The divestiture of the Bell System and
20 the establishment of a number of pro-competitive regulatory policies (such as equal

1 access presubscription) opened the long distance (interLATA) market to effective
2 competition and resulted in a host of consumer benefits. The long distance industry, once
3 characterized by a single dominant provider of high-priced telephone services, has
4 evolved dramatically over the past fourteen years and is now subject to effective
5 competition.[3]

6 **Q. HAS THIS EVOLUTION TO A COMPETITIVE MARKET MODEL BEEN**
7 **CAPTURED IN THE FEDERAL TELECOMMUNICATIONS ACT?**

8 A. Yes. The public policy evolution toward a full embrace of competition as the primary
9 allocator of telephony resources received a major boost with the passage of the
10 Telecommunications Act of 1996. The Act contains a number of specific pro-
11 competitive features and requirements designed to introduce competition into all aspects
12 of telephone service, including, most notably, local exchange service. For example,
13 Section 253 calls for the removal of barriers to entry and Section 257 requires that as a
14 matter of national policy, the FCC "seek to promote the policies and purposes of this Act
15 favoring . . . vigorous competition." Other sections of the Act require ILECs to unbundle
16 their network elements and make these available to new entrants on nondiscriminatory
17 terms. The purpose of these requirements is to relieve these new entrants of the
18 overwhelmingly daunting task of replicating entire local exchange networks to be able to
19 provide local exchange telephone services and, thereby, accelerate the pace at which

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1 [3] See, e.g., David L. Kaserman and John W. Mayo "Competition and Asymmetric Regulation in Long-Distance
2 Telecommunications: An Assessment of the Evidence," CommLaw Conspectus, Vol. 4, Winter 1996, pp. 1-26.

1 competition develops.

2 As a consequence of the Act, it is clear that both state and federal policymakers are

charged with the task of affirmatively promoting competition in the provision of local exchange telephone service. As noted by the Federal Communications Commission:

> The Telecommunications Act makes it clear that the public interest requires that the public interest standard embody a policy structure designed to promote both competition and deregulation. Indeed, the Act is quite explicit in its statement that the aims of the Act include the establishment of a "pro-competitive, deregulatory national policy framework designed to . . open [ ] all telecommunications markets to competition."[4]

Importantly, this standard, as well as that set out in WAC 480-143-050 requires the Commission, prior to approving this merger, to determine whether it serves or harms the public interest. In doing so, the Commission should determine whether the proposed merger affirmatively enhances competition, something which is clearly in the public interest. Thus, while traditional regulatory policy has been centered around the notion of <u>protection</u> from monopoly, the new regulatory paradigm must be centered around the concept of <u>promotion</u> of competition.[5] That is, traditional regulatory policy has acted to protect incumbent utilities from competition and, in turn, protect consumers from the resulting monopoly provider. Under this new regulatory paradigm, however, the policy goal is substantially redirected to one of enabling competition. Enabling competition, in turn, involves the dual tasks of: (1) promoting competition wherever

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[4] Memorandum Opinion and Order, <u>In the Application of NYNEX Corporation and Bell Atlantic Corporation for Consent to Transfer Control of NYNEX and its Subsidiaries</u>, Adopted August 14, 1997, ¶ 31 ("<u>BA-NYNEX Merger Order</u>").

[5] I note with full concurrence the standard caveat that policymakers should not seek to promote competition by protecting competitors.

1 possible; and, (2) protecting the competitive process as it emerges in markets that have
2 historically been characterized by monopoly supply. In short, the 1996 Act seeks to fully
3 enable the competitive provision of all telecommunications services.

4 **Q. HAVE THE PROCOMPETITIVE OBJECTIVES OF THE ACT BEEN**
5 **REALIZED?**

6 A. No. In the three and a half years of post-Act implementation efforts, a number of pro-
7 competitive policy measures designed to open and accelerate the onset of competition
8 have been pursued. Nonetheless, it is generally conceded at this point that local exchange
9 markets are proving considerably more difficult to open than many observers had
10 anticipated. The result is that nearly three full years after the passage of the 1996 Act,
11 ~~nearly~~almost all local access lines in the United States remain under the direct control of
12 incumbent local exchange carriers. Moreover, as noted by the FCC, a number of
13 significant barriers to entry into the local exchange market remain firmly in place.[6]
14 Finally, and of particular importance to the proposed merger of Bell Atlantic and GTE,
15 the entry process has been further deterred by the entrenched and potentially growing
16 incentive and ability of ILECs to engage in strategic measures designed to foreclose the
17 entry of new competitors.

18 **Q. IS THIS MERGER CONSISTENT WITH THE PROCOMPETITIVE INTENT OF**
19 **THE ACT AND WASHINGTON LAW?**

1 [6] BA-NYNEX Merger Order, ¶ 61.

1 A. No. Against this backdrop of a public policy thrust designed to enable competition, a

2 merger between two of the largest monopoly providers of telecommunications services in

3 the United States is inherently suspect. This suspicion is accentuated by what many

4 consider to be the failure to this point to see the widespread emergence of competition in

5 the provision of local exchange services in the United States.

6 **Q. IS THE PROPOSED MERGER LIKELY TO ACCELERATE OR FRUSTRATE**

7 **THE ONSET OF LOCAL EXCHANGE TELEPHONE COMPETITION?**

8 A. It is to that question that I now turn.

9 **IIV. THE MERGER PARTICIPANTS AND MARKET ENVIRONMENT**

10 **Q. IS BELL ATLANTIC MONOPOLISTIC IN LOCAL EXCHANGE SERVICES?**

11 A. Yes. Bell Atlantic controls roughly forty million domestic access lines.[7] Bell Atlantic is

12 positioned with control over what the company itself refers to as "the most valuable

13 assets in the communications industry: high-quality 'first-mile' connections to

14 customers."[8] Bell Atlantic provides local exchange services, local exchange access

15 services, intraLATA long distance services and wireless telephony services.

16 **Q. IS GTE A MONOPOLIST WITH RESPECT TO LOCAL EXCHANGE**

17 **SERVICES?**

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1 [7] Bell Atlantic 1997 Annual Report, p. 2.

1 [8] Id., p. 4.

1 A. Yes. GTE controls over 27 million access lines.[9] GTE provides local exchange, local

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1 [9] GTE 1997 Annual Report, p. 1.

1 exchange access, long distance (both intra and interLATA) and wireless communications.

2 GTE has established a strategy to "create a national presence" and "compete in key

3 national markets."[10] Moreover, prior to its proposed merger with Bell Atlantic, the

4 company launched "a competitive local-exchange carrier that will market the full

5 spectrum of GTE services in key markets, without regard to franchise boundaries."[11]

6 **Q. DO BELL ATLANTIC AND GTE MARKETS DEMONSTRATE ANY**

7 **COMPETITIVE CHARACTERISTICS?**

8 A Barely. The vast majority of services provided by Bell Atlantic and GTE exhibit

9 monopoly or near monopoly conditions. While the intent of the Telecommunications Act

10 was to alter this situation, the task is far more complicated than simply declaring that

11 competitive rather than monopoly supply is desired. A particularly daunting aspect of

12 introducing competition into local exchange markets is that, for the foreseeable future,

13 new firms will be dependent upon the cooperation of the ILECs to provide access to their

14 essential network facilities so that the new firms can provide retail-level service. This

15 dependency, together with virtual monopoly supply of local exchange access, creates

16 myriad opportunities for ILECs to engage in actions designed to exclude efficient entry

17

1 [10] Id., p. 2.

1 [11] Id.

1 and delay the growth of competition in the provision of local exchange services.[12]

2 **Q. CAN YOU GIVE SOME EXAMPLES?**

3 A. Yes. Specifically, local exchange companies have monopoly control over the facilities
4 necessary to provide local telephone services. In this situation, a pure unregulated
5 provider could raise prices of these monopoly elements to extract monopoly profits. The
6 fact that regulation serves to limit the ILECs' monopoly rent-taking by limiting prices,
7 however, also inadvertently provides the incentive for these companies to pursue those
8 rents in related markets such as the long distance market. Moreover, regardless of
9 regulation, ILECs also have the incentive to defend their extant monopoly power by a
10 variety of exclusionary practices, including but not limited to vertical price squeezes,
11 bundling or tying, price discrimination, and, nonprice (quality) discrimination.

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1 [12] As an example of how one state has evaluated the degree of competition and Bell Atlantic's attempted
2 characterization of it, we have the following from Pennsylvania as reported by Communications Daily, August 3,
3 1998:
4
5 **Administrative law judge (ALJ) for Pa. PUC recommended rejection of March petition by**
6 **Bell Atlantic Pa. for rate deregulation of business local exchange service on ground it's fully**
7 **competitive.** ALJ Michael Schnierie said BA's assertion that effective local business competition
8 exists when it has 96% business market share "borders on the ridiculous." He said BA's own
9 figures show that while it exchanged 1.3 billion traffic min. with local competitors in 1997, it
10 carried 88 billion min. between its own local customers. Schnierie in Doc. P-00971307 said Bell
11 Atlantic's reliance on local competitor growth rates rather than market shares to demonstrate
12 effective competition is "comically transparent" because any growth from zero starting point will
13 look huge. BA use of growth rates to demonstrate competition might hold water, he said, if local
14 competitors were able to freely enter Bell Atlantic exchanges in response to its price moves. But
15 he said free entry simply doesn't exist in Bell Atlantic's territory because of its continuing inability
16 to correct chronic problems with operation support system access, network unbundling,
17 collocation. He said BA's failure to correct those problems in 5 years since passage of state
18 competition law and 2-1/2 years after passage of federal Telecom Act "suggest that BA-Pa. is
19 making somewhat less than its best effort to meet these critical needs."

1 ~~I~~VI. COMPETITIVE CONSEQUENCES OF THE PROPOSED MERGER

2 **Q. HOW WILL THIS MERGER BE ANALYZED FROM AN ECONOMIST'S**
3 **ANTITRUST PERSPECTIVE?**

4 A. Economic analyses of proposed mergers for antitrust purposes typically follow a fairly
5 standard (and, I believe, generally sound) approach. Under this approach, post-merger
6 industry concentration, the magnitude of the change in concentration brought about by the
7 proposed merger, barriers to entry, and other relevant factors are all weighed within a
8 consistent and analytically valid framework. That basic framework is reflected in the
9 most recent DOJ/FTC Horizontal Merger Guidelines. In addition, the Department of
10 Justice 1984 Vertical Merger Guidelines provides additional factors relevant to an
11 analysis of horizontal effects that may emanate from non-horizontal mergers. My
12 analysis of the likely economic consequences of the proposed BA/GTE merger follows, in
13 large measure, these prior merger policy statements.

14 **A. Market Definition.**

15 **Q. WHAT IS THE FIRST STEP IN THE ANALYSIS UNDER THESE**
16 **GUIDELINES?**

17 A. As these Guidelines explain, the first step in any merger analysis must involve market
18 definition. Specifically, the relevant market or markets likely to be affected by the
19 proposed acquisition must be delineated across both the product and geographic

1 dimensions.[13] The purpose here is to identify the relevant products and geographic areas
2 within which the two firms either currently compete or, absent the merger, are likely soon
3 to begin competing.

4 **Q. IN WHAT RELEVANT PRODUCT MARKETS WOULD BELL ATLANTIC AND**
5 **GTE COMPETE?**

6 A. With regard to the proposed Bell Atlantic/GTE merger, it is relatively straightforward to
7 specify several product markets within which the two firms can (and, to a limited extent,
8 already do) compete. Specifically, local exchange services, local exchange access, and
9 long distance services (including both intraLATA toll and interLATA offerings) represent
10 currently identifiable relevant product markets. Additionally, it is widely believed that a
11 distinct demand is likely to emerge in the near future for a bundled service offering that
12 includes both local exchange and long distance services. (In fact, Bell Atlantic and GTE
13 argue that the emergence of the bundled services product market is one of the reasons that
14 they need to merge).[14] Therefore, these four service offerings -- local exchange services,
15 local exchange access, long distance, and bundled services -- constitute the relevant

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1 [13] For a discussion of market definition, see David L. Kaserman and John W. Mayo, Government and Business: The
2 Economics of Antitrust and Regulation, The Dryden Press, Fort Worth, Texas, 1995, pp. 111-116.
1 [14] Joint Merger Application, pp. 8-10.

1 product markets for purposes of this evaluation.[15]

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1 [15] The FCC has recognized that bundled services are emerging as a relevant product market. See, e.g., BA-
2 NYNEX Merger Order ¶ 52. Moreover, while my analysis focuses on voice telecommunications
3 services, I recognize that Internet backbone services have been separately identified by the
4 Commission. See Memorandum Opinion and Order, Application of WorldCom, Inc. and MCI
5 Communications Corp. to Transfer Control of MCI Communications Corp. to WorldCom, Inc.,
6 Adopted Sept. 19, 1998, &¶ 22.

Q. AFTER DEFINING THE MARKET, WHAT IS THE NEXT STEP?

A. Next, with regard to the geographic dimension of the market, the market definition must account for the rather unique feature of telecommunications demand. More precisely, that demand tends to point toward a host of point-to-point markets for telecommunications services. Each household may be seen to have a demand for point-to-point calling that is, from a demand-side perspective, not substitutable for calling between any other two points. Traditionally, however, the households within a local exchange company's service territory face a common set of telecommunications services and providers. In this case, as the FCC has noted, it is possible to identify a somewhat more aggregate-level geographic market to encompass the area within which households face similar choices.[16] Under this criterion, two relevant geographic markets may be identified which correspond to the two ILECs' franchised territories. Given this relatively narrow market definition, then, the merging firms generally may be viewed as operating in separate geographic markets. Consequently, under this view, the merger is not a direct horizontal acquisition. But, as explained below, the merger nonetheless has a significant competitive impact through channels other than industry concentration.[17]

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[16] Id. ¶ 51.

[17] Of course, adjacent ILECs may have already entered one another's territories in which case they would be actual competitors. In assessing the competitive impact of the merger using the more narrow geographic market definition, I conservatively assume that no such entry has occurred and that Bell Atlantic and GTE are not actual competitors. Relaxation of this assumption would only strengthen ~~our~~my conclusion that the merger would retard competition.

1 **Q. DO BELL ATLANTIC AND GTE USE THIS SAME TYPE OF ANALYSIS IN**
2 **THEIR APPLICATIONS?**
3 A. Despite the fact that the FCC has used this analysis in the other ILEC mergers it has
4 considered, Bell Atlantic and GTE maintain that there is a developing national market for
5 telecommunications services.[18] But even assuming arguendo that this is true, it would
6 mean that Bell Atlantic and GTE are actual competitors and the merger has a direct
7 horizontal impact on industry concentration. For purposes of analysis, then, I analyze the
8 competitive consequences of the proposed merger between Bell Atlantic and GTE under
9 both of these alternative geographic market definitions.

10 **The Impact of the Proposed Merger on Monopoly Power, Exclusionary Conduct,**
11 **and Barriers to Entry.**

12 **Q. DOES THIS MERGER RAISE CONCERNS ABOUT MARKET POWER AND**
13 **BARRIERS TO LOCAL COMPETITION?**
14 A. Yes. Regardless of which geographic market is selected, the proposed merger raises a
15 number of troubling concerns regarding the development of competition in local
16 exchange and local exchange access markets. Specifically, if consummated, the merger
17 will enhance the combined firm's control over price (monopoly power) and increase both
18 the ability and incentives for the combined company to engage in exclusionary conduct
19 designed to undermine the emergence of competition in the very markets where it is most

1 [18] Joint Merger Application, p.11; McCallion Direct Testimony, p. 11.

1 needed. Additionally, the merger would detract from the growth in competition that

1 would otherwise occur by elimination of an important potential competitor for Bell
2 Atlantic and GTE customers. Finally, under the mandate of the 1996 Act to create a "de-
3 regulatory national policy framework," the merger perversely and simultaneously acts to
4 both (1) heighten the need for more regulatory oversight, and (2) reduce the ability of
5 regulators to identify, monitor and enforce competitive behavior.

6 **Q. DOES THIS MERGER AFFECT GTE'S OR BELL ATLANTIC'S CONTROL**
7 **OVER MONOPOLY FACILITIES?**

8 A. Only to entrench such control further. One of the most vexing aspects of introducing
9 competition into local exchange telephony in the United States stems from the ILECs'
10 monopoly control of local facilities. This control, together with ILECs' vertical
11 integration into other telecommunications services that are, or could be, provided by
12 competitors create incentives for the ILECs to use this control to exclude rivals.[19] This
13 exclusion may be accomplished by engaging in price-based exclusionary tactics (e.g.,
14 vertical price squeezes) or non-price strategies such as denying, delaying, or degrading
15 access to its network. Unfortunately, the proposed merger of Bell Atlantic and GTE will
16 exacerbate both the incentives and ability to carry out such exclusionary practices.

17 **Q. HOW WILL THE MERGER EXACERBATE THESE INCENTIVES?**

18 A. For example, consider the fact that competitors of ILECs that purchase local exchange

1 [19] For an excellent analysis establishing the existence of incentives for the bottleneck owner to engage in
2 discriminatory practices against its rivals, see Nicholas Economides, "The Incentive for Non-price Discrimination by
3 an Input Monopolist," *International Journal of Industrial Organization* 16, 271-284.

1 access are typically made to pay access charges that are well in excess of the incremental
2 cost of providing that service. Assuming Bell Atlantic were permitted to enter the long
3 distance market before its access charges were reduced to cost, a call placed between a
4 Bell Atlantic exchange and a GTE exchange via an interexchange carrier (IXC) would
5 result in originating access charges (in excess of the incremental cost of providing this
6 access) paid to Bell Atlantic and terminating access charges (also in excess of costs) paid
7 to GTE. This impact will be directly felt by Washington consumers through increased
8 interLATA calling rates.

9 **Q. COULD YOU GIVE A NUMERIC EXAMPLE OF THIS POTENTIAL PRICE**
10 **SQUEEZE?**

11 A. Suppose for illustration purposes that the incremental cost of either originating or
12 terminating access is $.01 per minute while the price of originating access is $.03 and the
13 price of terminating access is $.02 per minute. For a call carried by the IXC, the "cost" it
14 faces, $.05 per minute, includes the price charged for originating access ($.03) and
15 terminating access ($.02). Consider the same call carried (pre-merger) by GTE. GTE
16 avoids the originating access charge and instead incurs an incremental cost of $.01. If
17 GTE carries the call to a customer presently residing in Bell Atlantic's service territory,
18 however, then GTE must (again, pre-merger) pay the same terminating access charges as
19 would be the case if an IXC were the carrier. Thus, pre-merger, GTE can be seen to
20 enjoy a "cost" advantage of $.02 [$.03 - $.01] relative to its IXC rivals. This "cost"
21 advantage is, of course, purely a function of the inflated access charges imposed for

1 providing local exchange access. Nonetheless, it provides GTE with control over the
2 price (monopoly power) charged for retail-level calls. Specifically, absent regulatory
3 intervention into retail markets, it permits GTE to raise prices above cost while still
4 displacing sales by a potentially more efficient rival.[20]

5 **Q. HOW WILL THE MERGER NEGATIVELY AFFECT THIS?**

6 A. Following the merger, GTE and Bell Atlantic's combined ownership of local exchange
7 access facilities increases this control over price. That is, by controlling both the
8 originating and the terminating ends of the call, GTE will incur only the incremental cost
9 of originating and terminating calls between these formerly independent customer groups
10 -- $.02 per minute. In contrast, an IXC providing the same call will face charges of $.05
11 ($.03 for originating access and $.02 for terminating access). Thus, the control over
12 retail-level pricing enjoyed by the post-merger GTE will have grown from $.02 (the pre-
13 merger advantage enjoyed by GTE) to $.03 (the post-merger advantage enjoyed by GTE).
14 The consequence of the merger, then, is seen to include an increase in the degree of
15 pricing control (monopoly power) enjoyed by GTE.

16 **Q. IS THERE ANOTHER ANTICOMPETITIVE DIMENSION TO THIS MERGER?**

17 A. Yes. Yet another problem created by the merger springs directly from the monopoly
18 control by GTE and Bell Atlantic of access lines. In a typical competitive market, the

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1 [20] While it has been suggested that imputation of the supra-competitive access charges into the ILEC's retail prices
2 will "solve" this problem, this solution suffers from a number of problems. For example, imputation methods, which
3 are highly contentious, must be developed, implemented and enforced, and can easily be evaded.

1 entry process is readily seen to reduce the ability of incumbent firms to control price. In
2 the instant situation, however, the merger of GTE and Bell Atlantic will act to dampen
3 the otherwise salubrious effects of the market entry process. Specifically, the merger will
4 insulate the combined companies' control over price, which, but for the merger would be
5 eroded (perhaps substantially) by any observed entry of facilities-based CLECs.

6 Consider, for example, the access charge pattern described earlier: $.01 being the
7 incremental cost of either originating or terminating access, $.03 being the price of
8 originating access, and $.02 being the price of terminating access. Recall that, in this
9 situation, GTE enjoys a $.02 "cost" differential relative to IXCs on calls originating in
10 GTE's territory and terminating in Bell Atlantic's service territory. In the absence of the
11 proposed merger, if an IXC were to enter the GTE territory and provide local exchange
12 access services on a sufficient scale and with the same efficiency as GTE ($.01), then
13 GTE's control over price (its advantage due to excessive pricing on originating access)
14 erodes. That is, entry will have the effect of eliminating the "cost" differential and
15 therefore GTE's monopoly power in the provision of retail services that depend on local
16 exchange access services. If, however, the proposed merger is consummated, then for
17 calls placed between the Bell Atlantic and GTE territories, Bell Atlantic-GTE will still
18 continue to enjoy a "cost" advantage relative to its IXC rivals, because it can now impose
19 terminating access charges on IXCs that it does not, itself, face. The point is that, absent
20 the merger, entry would erode the monopoly power enjoyed by GTE and Bell Atlantic;
21 but, if the merger is consummated, then this same entry will be less effective in reducing

1 GTE's and Bell Atlantic's control over price.

1 **Q. ARE THERE ANY OTHER CONCERNS WITH THIS MERGER?**

2 A. Yes. Finally, and perhaps most fundamentally for present purposes, the merger would
3 enhance incentives for the combined firm to engage in non-price exclusionary conduct in
4 order to protect its local monopoly from competition. To see this, note that the success of
5 widespread entry is critically dependent upon the quality with which these new entrants
6 are able to provide local exchange services in competition with ILECs. Because access to
7 ~~incumbent local exchange~~ILEC facilities will remain a critical input that CLECs need to
8 purchase from ILECs, however, the success of the entry process will depend in a very
9 critical way upon the timely provision of high quality, nondiscriminatory interconnection
10 by Bell Atlantic and GTE to prospective retail-stage rivals. While neither Bell Atlantic
11 nor GTE has been particularly forthcoming in its provision of such high quality
12 interconnection services to this point, the merger will further erode any incentives for the
13 post-merger Bell Atlantic to cooperate with new entrants.

14 **Q. CAN YOU GIVE AN EXAMPLE?**

15 A. Yes. Specifically, entry by CLECs is envisioned to occur across wide geographic areas
16 "without regard to franchise boundaries." If, however, Bell Atlantic or GTE engage in
17 actions that delay, deny, or degrade the quality of access to the new entrant prior to the
18 merger, the result is that the reputation of the new entrant is harmed not only in the
19 specific geographic location where the anticompetitive sabotage is undertaken but also in

1 other geographic areas where the new entrant competes or is contemplating entry.[21] That
2 is, if, say, Bell Atlantic or GTE engage in an action that harms the reputation of a CLEC
3 in area A, the company-wide reputation of the CLEC is harmed and this will make entry
4 into other geographic locations correspondingly more difficult.

5 Moreover, the anticompetitive effects of delaying, denying, or degrading access are not
6 limited to harm inflicted on the rivals' reputation for providing local exchange service.
7 If, as anticipated, Washington consumers are anxious to purchase bundled
8 telecommunications offerings, then damage inflicted on new entrants through the
9 discriminatory provision of local exchange access will spill over to affect the ability of
10 new entrants to profitably provide bundled service offerings.

11 **Q. HOW DOES THE MERGER CHANGE THE INCENTIVES FOR GTE'S AND**
12 **BELL ATLANTIC'S ANTICOMPETITIVE BEHAVIOR?**

13 A. Prior to the merger, any such anticompetitive actions undertaken by either Bell Atlantic or
14 GTE are privately beneficial to them. However, prior to the merger, the full (private, but
15 not public) benefit of such competitive sabotage is not internalized, because Bell Atlantic
16 cannot reap the benefits of its own entry-deterring tactics that spill over to result in
17 reduced entry into GTE's service territories. Similarly, prior to the merger, GTE is
18 unable to capture fully the entry-deterring benefits of anticompetitive actions it

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1 [21] This point is similar to remarks expressed by Sprint in the proposed SBC/Ameritech merger. See Declaration of
2 Michael L. Katz and Steven C. Salop, "Using a Big Footprint to Step on Competition: Exclusionary Behavior and
3 the SBC-Ameritech Merger," October 15, 1998.

1 undertakes in its own service territory that spill over to cause reduced entry into Bell
2 Atlantic's territory. Following the merger, however, Bell Atlantic/GTE will be able to
3 more fully capture the benefits of actions it undertakes to delay, deny or degrade access.
4 Such internalization of the profit-enhancing effects of sabotage of CLECs' entry, then,
5 creates post-merger heightened incentives to engage in such exclusionary conduct.
6 Consequently, it is quite likely that following the merger, the combined Bell
7 Atlantic/GTE will take an even more aggressive posture toward the provision of local
8 exchange access services that will have the effect of raising barriers to entry into the local
9 exchange and bundled telecommunications markets.

10 **C. The Impact of the Proposed Merger on Regulatory Oversight.**

11 **Q. HOW DOES THE MERGER AFFECT REGULATORY OVERSIGHT?**

12 A. The proposed merger involves firms that, due to their substantial monopoly power, are
13 subject to direct controls by both state and federal regulatory agencies. As a result, it is
14 feasible that adverse competitive consequences will derive from the merger's impact on
15 the ability of regulators to detect and punish exclusionary conduct by the regulated firms.
16 That is, given an enhanced incentive and ability for the merging companies to exercise
17 their monopoly power through both price and non-price strategies, the need for regulatory
18 oversight increases commensurately. If the merger simultaneously reduces regulators'
19 ability to perform this oversight function, then anticompetitive conduct can be expected
20 to escalate a fortiori.

1 Consideration of both the type of regulatory oversight required to promote and protect
2 emerging competition in local exchange markets and the methods used to carry out such
3 oversight strongly suggests that the proposed merger will adversely affect that important
4 regulatory function. Specifically regulators have traditionally (and, with the advent of
5 emerging competition, increasingly) utilized observations on the performance of all
6 regulated firms to establish benchmarks against which to judge the behavior of individual
7 companies under their jurisdiction.[22] Questions involving the technical feasibility of
8 alternative interconnection arrangements and the quality of ILEC-supplied inputs are
9 particularly amenable to such benchmarking. And it is precisely such questions that are
10 fundamental to enforcement of the 1996 Act's provisions and are already emerging as an
11 integral part of its implementation.

12 **Q. WHAT TYPES OF PROBLEMS CAN BE IDENTIFIED WITH THE MERGER**
13 **RELATIVE TO BENCHMARKING?**

14 A. Two adverse effects of the proposed merger related to the use of benchmarking can be
15 identified. First and most obvious, by eliminating the sixth largest ILEC as an
16 independent firm, the merger would reduce the already dwindling set of benchmark
17 companies that regulators can employ to at least partially resolve the informational
18 asymmetry that confounds regulators' (and competitors') efforts to enforce non-

1 [22] The Declaration of Joseph Farrell and Bridger M. Mitchell, "Benchmarking and the Effects of ILEC Mergers,"
2 Oct. 15, 1998, filed on behalf of Sprint in the SBC/Ameritech merger case, provides a rich discussion of
3 benchmarking and its role in regulatory enforcement efforts. The arguments I present here are drawn from that
4 Declaration.

1 discriminatory provision of monopoly inputs to the ILECs' nascent competitors. This
2 loss has particular impact on new services and technologies where there are few
3 established standards for judging ILEC conduct. In short, the loss of one more significant
4 benchmark company means that the likelihood that regulators will be able to identify and
5 confidently attack discriminatory treatment of both actual and potential competitors is
6 reduced.

7 Second, as the number of benchmark companies falls, the likelihood that any one of the
8 remaining firms will behave in a non-discriminatory fashion (and, thereby, set the
9 benchmark standard) is reduced as well. The fewer the number of firms setting the
10 benchmark, the more likely it is the firms can maintain a uniform standard and protect
11 against "cheating" whereby a member breaks ranks in order to gain a competitive
12 advantage or seek favor with regulators.

13 **Q. WHAT IS THE EFFECT OF THIS?**

14 A. The overall result of both of these effects is to exacerbate the problem, discussed earlier,
15 of the increased incentive and ability for the merged company to engage in such
16 exclusionary conduct. That is, a merged BA/GTE will have a greater incentive and
17 ability to sabotage new entrants' attempts to compete; and, simultaneously, regulators
18 will have a reduced ability to detect and prevent such behavior.

1 D. The Impact of the Proposed Merger on Potential Competition~~(I am proposing~~
2 ~~to remove this discussion on potential competition(plus a reference to it in the front), because it~~
3 ~~does not seem likely that BA will invade GTE Iowa. Any thoughts about whether the case would~~
4 ~~be weakened thereby?)~~

5 **Q. WHAT EFFECT DOES THIS PROPOSED MERGER HAVE ON POTENTIAL**
6 **COMPETITION?**

7 A. As noted earlier, a traditional view of the relevant geographic market suggests that the
8 acquisition of GTE by Bell Atlantic is not strictly horizontal. Several anticompetitive
9 concerns arise, nonetheless, in this context. To this point, I have discussed such merger-
10 induced concerns that stem from increased monopoly power, heightened levels of
11 exclusionary conduct, elevated barriers to entry, and diminished ability to detect and
12 punish anticompetitive exclusionary behavior. Another important set of problems raised
13 by the proposed merger of Bell Atlantic and GTE stem from the fact that the purchase
14 eliminates the prospect that each company's assets will be used as a competitive force
15 against the other's.

16 **Q. IS THERE COMPETITIVE DAMAGE THAT RESULTS FROM THE MERGER?**

17 A. Yes. The competitive damage that results from the demise of GTE (Bell Atlantic) as a
18 prospective entrant into Bell Atlantic's (GTE's) service territory depends on several
19 factors: (1) whether GTE (Bell Atlantic) is a likely entrant into Bell Atlantic (GTE)
20 territories and if so, then one must assess the damage done to the future of competition as

a consequence of the elimination of both these companies' assets from the ranks of prospective competitors; (2) whether GTE (Bell Atlantic) is positioned favorably relative to other potential entrants, so that its assets might be brought to bear more quickly or with greater force than other prospective entrants; and (3) whether there is sufficient competitive pressure from within the Bell Atlantic (GTE) geographic market to insure that regardless of the elimination of GTE (Bell Atlantic), consumers are, nonetheless, assured competitive supply.

1 **Q. WHAT DO YOU CONCLUDE FROM AN ANALYSIS OF THE ABOVE**
2 **FACTORS~~THIS IMPACT~~?**

3 A. The factors all unambiguously compel the conclusion that the elimination of Bell Atlantic
4 and GTE as competitors will harm social welfare in both territories. Assessment of the
5 relevant product markets within each company's territory indicates that Bell Atlantic and
6 GTE face precious little competition. Bell Atlantic and GTE each control the vast
7 majority of access lines within their respective service territories and continue to enjoy
8 barriers to entry into these markets. Accordingly, to the extent that the Act's drive to
9 enhance competition in telecommunications markets is to be taken seriously, it must be
10 acknowledged that such competition must, at least initially, come from firms that
11 presently are only "potential competitors." In this context, an analysis of the geographic
12 and product markets presently served by each company strongly suggests that, absent the
13 merger, GTE is a very likely entrant into the service territory presently served by Bell
14 Atlantic. Moreover, in those geographic areas where GTE provides service contiguous
15 with or very near Bell Atlantic (e.g., Pennsylvania and Virginia), Bell Atlantic is
16 favorably positioned to begin to compete for customers presently served by GTE.

17 The fact that both companies have a long tradition of providing virtually the same
18 services also creates the likelihood of cross-entry on a forward-going basis. Specifically,
19 the fact that Bell Atlantic and GTE have the internal company structures to support the
20 provision of local exchange and local exchange access services and considerable

1 experience providing these services enhances each company's knowledge of basic

2 demand and cost conditions in these markets. This experience-based knowledge

3 regarding demand and cost conditions in the provision of local exchange services acts to

4 reduce the uncertainty and risks that new entrants without this expertise face.

5 **VII.CONSIDERATION OF APPLICANTS' RATIONALE FOR**
6 **THE PROPOSED MERGER**

7 **Q. HOW DO BELL ATLANTIC AND GTE CHARACTERIZE THEIR MERGER TO**

8 **THhIS COMMISSION?**

9 A. In their Joint Merger Application and supporting testimony, ~~**[find cites in proposal]**~~ Bell

10 Atlantic and GTE present a number of arguments and some limited evidence to support

11 the claim that the net effect of the proposed merger will be pro-competitive. In a nutshell,

12 the basic argument is that, together, these companies can and will launch competitive

13 incursions into other ILECs' markets that, in isolation, they either cannot or will not

14 launch. The credibility of this argument, however, is called into question by several

15 errors and inconsistencies contained throughout the Joint Merger Application. While I

16 will not undertake here a detailed rebuttal of every point with which I disagree, I believe

17 it is important to point out several of the more egregious flaws in the analysis presented to

18 support this merger. I focus on two of these, although both are related.

19 **Q. WOULD YOU DESCRIBE ONE OF THE FLAWS?**

20 A. Yes. First, the core argument -- that this merger is necessary to implement the expanded

1 entry plans of these two firms[23] -- contains several fundamental internal inconsistencies.

1 [23] McCarren Direct Testimony, pp. 3-5; McCallion Direct Testimony, pp. 11-12.

1 For example, for some unspecified reason, it is claimed that it is necessary for the largest
2 and the sixth largest ILECs to merge in order for them to be able to enter local exchange
3 markets out of region; but, at the same time, these companies claim to face a substantial
4 threat of entry by numerous, much smaller companies in their own territories.[24] In other
5 words, these firms are arguing that they have to be exceedingly large to enter other
6 ILECs' markets, but even very small companies can successfully enter their markets.

7 Also, Bell Atlantic and GTE claim that tremendous social welfare gains will be reaped by
8 a combined Bell Atlantic/GTE entering other ILECs' territories (presumably due to the
9 absence of any significant competition -- either actual or potential -- in those markets);[25]
10 but, at the same time, they implicitly argue that the other ILECs continue to possess
11 substantial monopoly power, but Bell Atlantic does not.

12 And finally, Bell Atlantic and GTE argue that, if they are allowed to merge, they fully
13 intend to compete vigorously with other ILECs;[26] but, at the same time, they claim that, if
14 they are not allowed to merge, they have no intention of competing with each other.[27] In
15 other words, they are arguing that, if this merger is approved, they will attack all markets,
16 but, if it is not, they will attack no markets.

17 **Q. WHAT DO YOU CONCLUDE ABOUT THESE INCONSISTENCIES?**

---

1 [24] McCallion Direct Testimony, pp. 17-18.
1 [25] *Id.* p. 17.
1 [26] *Id.* p. 17.
1 [27] McCarren Direct Testimony, p. 11.

1 A. Such fundamental inconsistencies cast considerable doubt on the view that this merger is:

2

1 (1) necessary for out-of-region entry by these ILECs to occur; (2) required for GTE's
2 widespread facilities to be put to pro-competitive uses; and (3) likely to yield any social
3 welfare gains. Pro-competitive claims built upon such a shaky foundation cannot support
4 the weight of a proposed merger of this magnitude.

5 My conclusion is that these assertions of GTE and Bell Atlantic are entirely without
6 foundation and that there is no need for them to merge in order to continue to
7 competitively offer an array of telecommunications services. In my view, they are each
8 currently large enough to be able to engage in their competitive strategies, including entry
9 into each other's territory, if they truly, fully intend to do so.

10 ~~**Q. WHAT IS ANOTHER FLAW?**~~

11 ~~A. Second, in an attempt to provide some much-needed empirical support for the argument~~
12 ~~that the proposed merger is likely to have net pro-competitive impacts, Bell Atlantic and~~
13 ~~GTE presented to the FCC a declaration by Professor Thomas Hazlett. In that~~
14 ~~declaration, Professor Hazlett reports the results of an event study that examines stock~~
15 ~~price reactions to announcement of the merger for four companies which Bell Atlantic~~
16 ~~and GTE claim are their competitors -- AT&T, MCI WorldCom, Sprint, and SBC.~~
17 ~~Finding that all four of these companies' stocks declined at the time the proposed merger~~
18 ~~was announced (July 28, 1998), Professor Hazlett concludes in his Declaration (**& 6)**~~
19 ~~**that:**~~

20 ~~**This serves as strong evidence that rational investors do not**~~
21 ~~**believe that the Bell Atlantic merger with GTE will increase**~~

1 prices for telecommunications customers. The reverse
2 interpretation -- that the merger is seen as increasing
3 competitive rivalry -- is the most reasonable conclusion.
4
5 Under certain circumstances, a properly conducted event study may
6 provide some limited evidence of the likely competitive consequences of a
7 proposed merger. In the instant case, however, the above conclusion is
8 completely unwarranted. In fact, given the market positions of the
9 companies whose stock prices are examined, the above evidence cannot
10 distinguish between a pro-competitive and an anticompetitive impact.
11 Indeed, given these market positions, the evidence appears to be more
12 consistent with the latter. As a result, it cannot be used to support
13 approval of the merger.
14
15 The inability of the observed negative stock price reactions to distinguish
16 the direction of the competitive effects of this merger stems from the fact
17 that the sample firms are not currently direct competitors of either Bell
18 Atlantic or GTE to any significant degree. Rather, three of these companies
19 presently are either potential competitors or present consumers that, under
20 current market conditions must rely upon these ILECs for
21 nondiscriminatory provision of essential inputs (unbundled network
22 elements, wholesale services, interconnection services, etc.) in order to
23 enter and compete in Bell Atlantic's and GTE's territories. Likewise, SBC is

1 a potential competitor that will need access to Bell Atlantic's network to

2 provide competitive local services.

3

4 As explained in Section IV[?], however, the proposed merger is likely to

5 result in a heightened incentive and ability for Bell Atlantic and GTE to

6 raise the prices of essential inputs and to implement exclusionary tactics

7 that will hamper or, in the extreme, prevent such entry. To the extent the

8 proposed merger facilitates such exclusionary conduct by these firms, the

9 stock prices of customers of the ILECs' intermediate goods and potential

10 entrants should be expected to decline in response to the announcement.

11 Consequently, the stock market reactions observed by Professor Hazlett

12 are equally, if not more, consistent with the hypothesis that the proposed

13 merger will have significant anticompetitive consequences -- raising input

14 prices to potential entrants and increasing non-price exclusionary conduct

15 which further increases barriers to entry. Therefore, the proffered evidence

16 simply cannot support the conclusion that is drawn from it. If anything,

17 this evidence tends to support the inference of an anticompetitive effect.

18

19 **Q. WHAT IS THE THIRDTHE OTHER RELATED FLAW?**

20 **A. Third, aAnother fundamental shortcoming in Bell Atlantic's and GTE's**

21 **arguments for approval of the proposed merger is the failure to provide a**

1 **convincing affirmative explanation of why the alleged competitive benefits**
2 **of this transaction cannot be achieved by independent entry of these two**
3 **firms into other ILECs' and each other's service territories. That is, why**
4 **must public policy sacrifice competition between these two companies in**
5 **order to obtain competition between them and other ILECs? As discussed**
6 **below, each of these companies already possesses more-than-adequate**
7 **resources to enable them to launch the sort of competitive activities they**
8 **promise will result from the merger. Clearly, such independent action will**
9 **have far greater pro-competitive effects than are likely to be realized from**
10 **the merged entity. Moreover, these effects will be felt not only in the other**
11 **ILECs' existing service territories but in Bell Atlantic's and GTE's regions**
12 **as well. Thus, the intensity of competition will be greater and it will be**
13 **realized in more geographic areas if the merger application is denied.**

14 **It is virtually always more profitable for rivals to merge than compete.**
15 **Where such profitability comes at the expense of competition, however,**
16 **consumers are harmed. While it is certainly understandable why Bell**
17 **Atlantic and GTE would prefer to join forces rather than attack each other's**
18 **markets or to attack other ILECs' markets independently, it is, nonetheless,**
19 **necessary for them to explain why such a union is required for competition**
20 **to occur. They have failed to do so here.**

1 **Q. WHY DO YOU BELIEVE THE ABOVE CONCLUSIONS BY GTE AND BELL**
2 **ATLANTIC ARE FLAWED?**
3 **A. It is understandable that GTE's and Bell Atlantic's new ventures,**
4 **particularly those outside of their traditional regions, would have negative**
5 **cash flows in the earlier periods of operation even if full cooperation were**
6 **to be accorded by the ~~incumbent local exchange companies ("ILECs").~~**
7 **~~Competitive Local Exchange Companies ("CLECs")~~ ILECs. CLECs have**
8 **certainly experienced negative cash flows in their early years as well.**
9 **Capital would flow into those ventures based on the investor's guess about**
10 **prospective earnings by following its existing, home-region customers to**
11 **new regions or by expanding to adjacent local territories. All else equal, it**
12 **matters not whether the investor in, say, Kirkland, Washington, is GTE, Bell**
13 **Atlantic, or the new BA-GTE. Ultimately-realized earnings will either reward**
14 **or punish the investor the same in absolute terms regardless of the size of**
15 **the investor's other assets.**

16 **Q. ARE THERE ANTI-COMPETITIVE IMPACTS IN GTE AND BELL ATLANTIC**
17 **TERRITORIES FROM THE MERGER?**
18 **A. ~~In addition,~~Yes. ~~w~~When a demonstrable effect of the merger is to**
19 **eliminate each party from entering the other's territory, then potential**
20 **competition is weakened in two regions. Instead of entering the other's**
21 **territory as CLECs, the parties would, in effect, be purchasing their way**

1 **into each other's current monopoly, thereby eliminating any risk they**
2 **would otherwise have to bear in investing in each other's regions and**
3 **reducing their risk from competitive incursion in the expanded home**
4 **territory. As individual firms, they would be in a position to compete with**
5 **each other for customers. As a merged firm, they, who are best positioned**
6 **to do so, do not compete against each other for any customers.**

7 **Competition is not only diminished in GTE's and Bell Atlantic's regions, but**
8 **in other regions as well. For example, in the case of Seattle,[28] the merger**
9 **would reduce the number of competitors to U S WEST by one: Rather than**
10 **both GTE and Bell Atlantic possibly positioning themselves to be entrants,**
11 **only the merged entity would do so.[29]**

12 **Q. IS THERE EVIDENCE TO SUPPORT YOUR VIEW THAT GTE'S AND BELL**
13 **ATLANTIC'S CONCERNS OVER THEIR ABILITY TO ENTER COMPETITIVE**
14 **MARKETS INDEPENDENTLY ARE OVERSTATED?**

15 **A. Yes. Given that, as explained below, GTE and Bell Atlantic clearly have the**
16 **ability to raise the capital necessary to fund both out-of-region local entry**
17 **and other business ventures, it would appear their concerns over**

---

1 [28] This would be true for any GTE territory abutting a large city whose area is predominantly controlled by an ILEC
2 other than Bell Atlantic.
1 [29] Although Bell Atlantic claims that it would not enter the market in Washington in the absence of this merger
2 (McCarren Direct Testimony, p. 11), there is no evidence that this is truly the case or that those plans won't change
3 in the future.

1 spreading fixed costs are that their shareholders would prefer a merger
2 that eliminates competition. Such concerns are clearly not cognizable in
3 determining whether this merger satisfies the public interest.

4 Size of the investor in local exchange markets has apparently not been an
5 issue so far as the financial markets have been concerned. As evidence
6 for this, we need only look at the current experience of several CLECs to
7 see that they are much smaller than either GTE or Bell Atlantic and yet
8 have been able to raise sufficient capital to procure the assets necessary
9 to enter local markets all across the United States. (Of course, the efforts
10 to deploy these assets and provide local services has been met with stiff
11 resistance by the ILECs.) In many cases, their entry strategy has been
12 accomplished in much the same manner as, and at a size similar to, that
13 apparently contemplated by GTE and Bell Atlantic.

14 Q. WHAT SMALLER COMPANIES ARE YOU REFERRING TO?

15 A. A look at a few CLEC examples will be instructive in showing how off-the-
16 mark GTE and Bell Atlantic are in their assertions about not being large
17 enough individually to enter out-of-region local markets or to achieve their
18 other business goals. Selected CLEC information about recent debt issue
19 sizes and interest rates they paid and the extent of the markets they serve
20 are taken from their August 1998, 10-Q reports filed with the SEC. Market

1 ~~capitalizations~~capitalizations are as of November 17, 1998. As these
2 examples show, the financial markets have been very forthcoming with
3 capital for these firms to use in entering the local service markets, and
4 these firms are midgets compared to either GTE or Bell Atlantic.

5 GST Telecommunications Inc (GSTX) --- As of June 30, 1998, GSTX had
6 over $1.1 billion in debt and $58.1million in preference shares. The interest
7 rate on its most recent debt placing was 10.5%. Its digital network
8 currently serves 41 markets in the Western states (*i.e.*, Arizona, California,
9 Hawaii, Idaho, New Mexico, Oregon, Texas and Washington). GTSX
10 articulates its own out-of-region strategy, very similar to that of GTE and
11 Bell Atlantic, in its quarterly report (10-Q) on page 8:

> 12 The company plans to build specific network segments
> 13 or to lease capacity as economically justified and as the
> 14 demands of its customers warrant. Management
> 15 believes that pursuing the "smart-build" approach
> 16 should permit the Company to provide for ongoing
> 17 capital expenditures on a "success basis" and allow the
> 18 Company to build its customer base through an
> 19 increased focus on sales, marketing and operations
> 20 support systems. "Smart-builds" also provide the
> 21 Company with the ability to address attractive service
> 22 areas selectively throughout its targeted markets.

23 The market capitalization of GTSX is $252 million.

24 WinStar Communications, Inc. (WCII) --- WCII has been able to issue $450
25 million in debt during 1997 and $450 million during the first quarter of 1998,

1 **when it also issued $193.1 million worth of preferred stock at a 7% rate.**
2 **WCII has recently paid interest rates in the 10-11% range. WCII currently**
3 **serves 27 markets, including Atlanta, Baltimore, Boston, Chicago,**
4 **Columbus, Dallas, Denver, Detroit, Fort Worth, Houston, Kansas City, Los**
5 **Angeles, Milwaukee, Minneapolis, New York, Newark, Oakbrook, IL,**
6 **Oakland Orange County, CA, Philadelphia, Phoenix, San Diego, San**
7 **Francisco, Seattle, Stamford, CT, Tampa and Washington, DC and will add**
8 **Miami, St. Louis and Cleveland by year end 1998. The market capitalization**
9 **of WCII is $1.17 billion.**

10 **ICG Communications INC (ICGX) --- ICGX has an outstanding**
11 **indebtedness of about $1.5 billion at interest rates ranging from 9 7/8% to**
12 **13 ½%, $72.8 million in capitalized lease obligations, and various preferred**
13 **stock issues at rates ranging from 6 ¾% to 14 ¼%. ICGX has 20 high**
14 **capacity digital voice switches and 15 data communications switches in**
15 **major metropolitan areas in California, Colorado, Ohio and the Southeast.**
16 **The market capitalization of ICGX is $1.03 billion.**

17 **RCN Corp. (RCNC) --- RCNC has raised slightly over $1 billion in the debt**
18 **market over the last year at rates ranging from 9.8% to 11 1/8% and raised**
19 **$113, 305 from issuance of more common stock. RCNC serves Boston,**
20 **New York City and Lehigh Valley, PA, and will soon serve Washington, DC,**

1 Las Vegas, Phoenix and California. The market capitalization of RCNC is
2 $970 million.

3 e.spire Communications, Inc (ESPI) --- ESPI has raised approximately $978
4 million from equity and debt issues at interest rates ranging from 10 5/8%
5 to 14 ¾%. It has 32 local networks in 19 states served by some 61
6 switches. The market capitalization of ESPI is $386 million.

7 Electric Lightwave, Inc (ELIX) --- ELIX has a $400 million revolving bank
8 credit facility that is guaranteed by its 83% owner, Citizens Utilities
9 Company. ELIX serves Portland, Seattle, Salt Lake City, Sacramento,
10 Boise, Phoenix, Los Angeles and Las Vegas. The market capitalization of
11 ELIX is $351 million.

12 McLeod USA, Inc (MCLD) --- MCLD financed debt of approximately $291.9
13 million in March 1998 at 8 3/8% interest. MCLD serves in Colorado,
14 Washington, Illinois, Indiana, Minnesota, Missouri, North Dakota, South
15 Dakota, Wisconsin, and Wyoming. The market capitalization of MCLD is
16 $2.17 billion.

17 Teligent, Inc (TGNT) --- TGNT received proceeds of $241.3 million in
18 February 1998 from debt at 11 ½% interest. TGNT has recently turned up
19 service in a few markets but projects to serve 74 metropolitan areas. TGNT

1 **has a market capitalization of $1.61 billion.**

2 **US LEC Corp (CLEC) --- CLEC received $87.333 million from its IPO in the**
3 **second quarter of 1998 and has very little debt. CLEC serves Atlanta,**
4 **Charlotte, Greensboro, NC, Knoxville, Memphis, Orlando and Raleigh, NC.**
5 **The market capitalization of CLEC is $353 million.**

6 **Q. WHAT DOES THE ABOVE INFORMATION CAUSE YOU TO CONCLUDE?**
7 **This sampling of CLECs indicates that~~they~~ there are small companies that**
8 **have been aggressively raising capital to attempt to enter local markets all**
9 **across the nation. It appears that they have had no difficulty in securing**
10 **funding for their ventures, which are identical or very similar to those that**
11 **GTE and Bell Atlantic claim to contemplate. Given barriers to providing**
12 **local services for fledgling CLECs, these ventures are very risky as**
13 **evidenced by the interest rates that the CLECs as a group have had to bear**
14 **for their debt. As a group, they have not yet begun to be profitable. Some**
15 **may become successful, others may not survive as going concerns and**
16 **some of these may eventually be taken over by other companies, including**
17 **some ~~Regional Bell Operating Companies (“~~RBOCs~~”)~~.**[30]

18 **By contrast, GTE and Bell Atlantic are very large companies. GTE's market**

1 [30] *See* "CLEC's: What's Really Going On?" Daniel P. Reingold, Merrill Lynch, June 19, 1998, p. 28.

1 **capitalization is $60.4 billion and Bell Atlantic's is $86.9 billion. GTE's debt**
2 **to equity ratio is 1.81 and that of Bell Atlantic is 1.44. The yield on**
3 **telephone bonds is just under 7% and falling. As out-of-region entrants,**
4 **their risk can be no greater than that faced by the CLECs and would most**
5 **likely be less, because they are already well known to their existing**
6 **customers, whom they intend to follow. They also have the back office**
7 **capabilities and local exchange expertise that are unmatched by CLECs.**
8 **Therefore, it is very clear that each company individually is of sufficient**
9 **size and has the borrowing ability to finance entry into new competitive**
10 **offerings, including into local markets outside of its current region in order**
11 **to follow existing customers and/or enter adjacent territories. They do not**
12 **need to merge in order to pursue new entry strategies.**

13 **~~B~~VIII.THE ILLOGIC OF THE NEED FOR A MERGER TO BE MORE**
14 **EFFICIENT**

15 **Q. GTE AND BELL ATLANTIC ARGUE THAT THEIR MERGING OF ASSETS**
16 **WILL REAP GREAT EFFICIENCIES. DO YOU AGREE?**
17 **A. No.**

18 **Q. WHY?**
19 **A. Because the available evidence in the telecommunications industry**
20 **suggests a wide range over which there are constant returns to scale --** ***i.e.*****,**

neither economies nor diseconomies of scale -- the focus should be on how efficient these companies are individually, at their respective, current scale levels. GTE and Bell Atlantic simply assert that ~~efficiencees~~efficiencies will arise from spreading the fixed cost of investments and by eliminating duplicative staff.[31] Nowhere do they evaluate the specifics of alleged efficiencies. Nor do they offer an analysis of why such candidate sources of savings could not be produced by exposing each company to competition.

Competition is known, after all, to drive firms to be efficient or die, and neither firm has yet been exposed to competition. Therefore, it is reasonable to question whether each firm is currently operating as efficiently as possible, given that they operated under a rate of return regime for several years. One hint might be the fact that each anticipates finding out and adopting the other's best operating practices. To the extent this is true, as they admit, it means that they individually are not operating on, but rather are above, the long run average cost curve. In plain English, it means that they are not operating efficiently.

COULD BELL ATLANTIC AND GTE ACHIEVE SIMILAR EFFICIENCIES AS INDEPENDENT COMPANIES

[31] Joint Merger Application, p. 10, 14; McCallion Direct Testimony, pp. 11-12.

1 **A.**

2 **Yes. ~~Also, i~~If they remain separate firms and pursue an out-of-region local**

3 **strategy, whether into each other's territory or otherwise, would they not**

4 **have incentives to take efficiency enhancing measures as they follow their**

5 **home customers across regional borders? I believe the answer is "yes."**

6 **Instead of merging to form a more formidable foe against competitive entry**

7 **into the larger, post-merger home territory and trading "best practices,"**

8 **they would be forced to determine best practices or perish, if they had to**

9 **compete against one another. For example, if Bell Atlantic is not using**

10 **best practices in some significant areas, then it deserves to have**

11 **competitors, including GTE, pick it apart by taking away its customers,**

12 **rather than having a stock swap with GTE. The prospect of being driven**

13 **out of business would, in turn, gives Bell Atlantic the incentive to take**

14 **measures to improve its practices and, perhaps, become better than GTE.**

15 **This is a crucial dynamic that would not have a chance to occur if the**

16 **merger were to take place.**

17 **DO YOU HAVE CONCERNS REGARDING WHETHER THE CLAIMED SAVINGS**

18 **WILL ACTUALLY BE REALIZED?**

19 **Yes. It is ~~also~~ at least questionable whether all of the claimed savings from**

20 **redundancies will be realized. It has been well-known to AT&T in its local**

21 **competition network element pricing cases, and has recently been**

1 **admitted by an economic expert from LECG,[32] a firm often used by GTE and**

2 **the RBOCs, that most, if not all, of the overheads of a firm are**

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1 32 *See* Declaration of Debra Aron, Proper Recovery of Incremental Overheads for Local Number Portability, *In the*
2 *Matter of Local Number Portability Before the Federal Communications Commission*, CC Docket No. 95-116, at 5-
3 15 (FCC July 29, 1998). (Attached hereto as Exhibit 1).

1 **variable along with its other business activity. There is very little, if any,**
2 **fixed cost in the long run. Because firms' overheads vary proportionately**
3 **with their size, potential cost saving from this merger cannot be a matter of**
4 **spreading fixed cost over more units of output beyond the short term. The**
5 **cost savings would have to derive from correctly sizing the variable**
6 **overheads and adopting best-practice standards for the operations**
7 **activities of the new entity. However, this leads again to the question of**
8 **whether competing as individual firms could accomplish these cost**
9 **efficiencies more effectively. My view is that competition would force the**
10 **firms to find the correct amounts of overheads and engage in best**
11 **practices, because it would hold them accountable for doing so. Having**
12 **them compete against each other would be preferable to depending on**
13 **their promises of future cost savings as a merged company that would**
14 **remain a monopoly.**

15

16

17 **IX.CONCLUSION**

18 **Q. PLEASE SUMMARIZE YOUR ANALYSIS OF THIS MERGER.**
19 **A. My analysis of the competitive consequences of the proposed Bell**

1 **Atlantic/GTE merger has followed a standard approach. I began with the**
2 **issue of market definition. I have chosen to analyze the merger's likely**
3 **effects under both the traditional approach for geographic markets as well**
4 **as using Bell Atlantic's and GTE's proposed national market definition.**
5 **Given these two alternative geographic market definitions, then, I have**
6 **evaluated the likely economic impact on exclusionary conduct, barriers to**
7 **entry, potential competition and regulatory oversight.**

1 **Q. DO YOU HAVE ANY CONCLUSIONS?**

2 **A. Yes. My evaluation yields the following conclusions:**

3 **If consummated, the merger can be seen to increase the merged firms'**
4 **monopoly power in Washington by heightening their ability to control**
5 **price.**

6 **If consummated, the merger will heighten incentives for exclusionary**
7 **conduct in Washington by the combined firm.**

8 **If consummated, the merger reduces potential competition substantially in**
9 **markets characterized by extremely high levels of concentration and**
10 **entry barriers (i.e., in precisely those markets where potential**
11 **competition is most crucial).**

12 **If consummated, the combination will heighten the need for regulatory**
13 **enforcement at the same time the Commission has established a goal of**
14 **promoting a deregulatory policy framework. Specifically, the merger**
15 **will increase the need for and complexity of the companies'**
16 **implementation of obligations required under the 1996 Act while**
17 **simultaneously inhibiting the ability of the Commission to perform**
18 **successfully the increasingly necessary oversight functions.**

19 **In sum, the competitive war for local exchange markets has only recently**
20 **been declared and only a few shots have been fired. Consumers stand to**
21 **benefit greatly from the competitive battles that are, hopefully, soon to be**

1 **waged. Lower prices, improved service, and innovative service offerings**
2 **will emerge as new and existing rivals aggressively fight for the huge**
3 **revenues at stake. This is not the time for armistices to be signed by the**
4 **prospective combatants. The peaceful life of the monopolist is simply**
5 **inconsistent with the policy goal of promoting competition in this industry.**
6 **Summarily, Washington consumers will not benefit by the merging of these**
7 **two mega-companies.**

8 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**
9 **A. Yes.**