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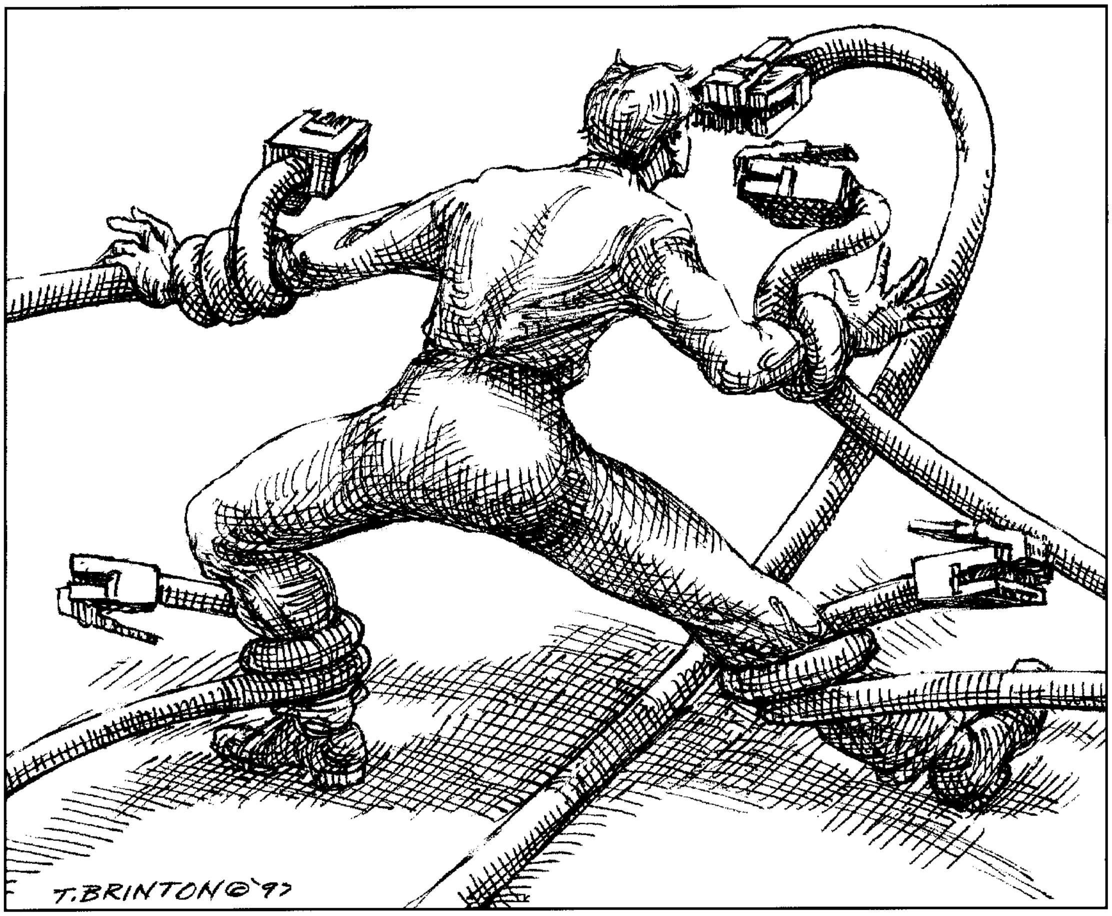

Calling the Shots

Big Mergers by powerful Phone Companies Could Render Consumers Powerless

By Matthew L. Cantor

Here is a glimpse at the possible telephonic future, which may look similar to our telephonic past.

Traditional long-distance providers, such as AT&T, whose profits from their long-distance operations continue to erode, will be acquired *by the remaining regional Bell operating companies*, each of which has a monopoly in the local telephone (or exchange services) market in the region where it is based. Because of regional Bell technical compliance with the Telecommunications Act of 1996, the Federal Communications Commission and state governments will allow regional Bells to offer long-distance services from virtually all 50 states.

Thus, Verizon, for example, will have the ability to offer long-distance services from virtually all of the states where it is the monopolist in the local exchange market and to compete for long-distance subscribers in states where it does not offer local exchange services. American consumers are likely to be left with three or four telephone powerhouses, each of which will offer "one-stop shopping" for local and long-distance services, and perhaps for wireless and high-speed Internet.

If this scenario plays out, the future of the telephone industry may reside in the hands of three or four monopolies that will offer an array of telephone services — monopolies that will look very similar, albeit on a smaller geographic scale, to the "Ma Bell" local exchange and long-distance monopoly that existed until the federal government broke it up in the early 1980s.

The odds that this future scenario will play out have increased recently as a result of reports that AT&T is discussing the sale of its long-distance business with the regional Bells.

It is generally thought that a certain minimum of players in a given market is conducive to robust price competition, product quality and innovation. Indeed, in recent years, the long-distance market, which has evidenced a substantial drop in prices ever since the breakup of the old AT&T and an even greater drop in prices at the same time that it has been entered by the regional Bells, may serve as model of how competitive forces can benefit the consumer.

Hence, at first glance, it would be proper for the antitrust authorities to question whether such consolidation will be an affront to antitrust maxims that state that mergers that are likely to substantially lessen competition are illegal. However, any antitrust review undertaken by these authorities likely will consider legal "defenses" and economic-efficiency arguments proffered by the merging parties. Antitrust authorities should be skeptical of arguments that favor consolidation of regional Bells and long-distance providers.

In order to pass antitrust scrutiny, the merging parties will have to convince authorities that regional Bell dominance in local exchange markets will not substantially lessen competition in long-distance markets after the proposed consolidation occurs. In other words, the merging parties will have to prove that a merged regional Bell and historic long-distance provider will not be able to abuse its dominance in a particular local market to harm competing long-distance providers, such as by hindering necessary interconnection between the regional Bell local network and competing long-distance providers.

In response to these concerns, proponents of this consolidation will be quick to point out that the federal district court sitting in the Western District of Washington, in evaluating regional Bell monopoly power, recently has argued that continued dominance by regional Bells is uncertain in light of the 1996 act's provisions that mandate the opening of regional Bell local exchange networks to local exchange competitors. *Metronet Serv. Corp. v. Qwest Corp.*, 2001 WL 765167 (W.D. Wash. April 16, 2001).

Likewise, the parties will identify wireless operators and cable providers as competitive threats to regional Bell dominance in the local exchange market. Hence, according to these parties, it will be unlikely that regional Bells will have the continued ability to use any market power that they have in the local exchange market to, for example, penalize long-distance providers who need to interconnect to regional Bell local networks.

Arguments made by the merging parties concerning the future erosion of regional Bell monopoly power in local exchange likely will be difficult to prove. To many, the 1996 act has been a failure of deregulation. For years, regional Bells have been mandated to open their local networks, and still there is no effective competition at the local exchange level. Further, it is uncertain, at best, whether cable providers will be able to offer competitive local telephone service.

Finally, the antitrust authorities will have to thoroughly scrutinize whether wireless services can be included within the definition of a local telephone market (e.g., they will have to determine whether a sufficient number of consumers would substitute wireless services for traditional local exchange services in response to a significant, nontransitory price increase).

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Even if these wireless services are included in the definition of a local telephone market, antitrust authorities will have to determine whether this finding would preclude a further finding of regional Bell monopoly power in such a wireless/wireline local market. It appears doubtful that the regional Bells will be able to prove that they do not have significant market power in a wireless/wireline market.

In order to prove that competition will not substantially be lessened in telephone markets, one also can expect that the parties to the theoretical consolidation will argue that such consolidation will lead to significant merger-specific efficiencies (i.e., cost savings), such as the elimination of redundant corporate structures. (The U.S. Circuit Court of Appeals for the District of Columbia Circuit recently held that a merger which demonstrates extraordinary efficiencies that are specific to that merger may pass antitrust muster. *FTC v. H.J. Heinz Co.*, 246 F.3d 708 (D.C. Cir. 2001).)

Indeed, the merging parties can be expected to argue that these significant efficiencies will lead to stronger, out-of-region long-distance competitors. For example, it is conceivable that if significant cost savings are achieved by combining local and long-distance services in one region, it will be easier for these entities to compete in long-distance markets that are outside of the local region dominated by the particular regional Bell offering that long-distance service.

In other words, in a hypothetical transaction between Verizon and AT&T, one would expect Verizon to argue that, because of the efficiencies that it will achieve in combining its local business with AT&T's long-distance business, it will be better positioned to compete in offering long-distance services in California, where it has no presence in the local market, than a stand-alone AT&T is currently.

This is because a merged Verizon and AT&T would be able to use the cost savings that it achieves in the region where its monopoly exists to support long-distance services where it does not have a monopoly.

The antitrust authorities, however, should be wary of this cross-subsidization argument. First, according to this argument, consumers of local service will be paying supracompetitive rates in order to subsidize regional Bell out-of-region long-distance operations. These local consumers, especially those that do not use long-distance service frequently, should not be penalized in the hope that real long-distance competition will continue in a world where the regional Bells dominate.

Further, one must question why regional Bells would want to compete away the higher prices that they achieve in local exchange by offering long-distance service in a region where they will face the same economic and interconnection problems that are being faced by MCI Worldcom, Sprint and AT&T.

Finally, if one-stop-shopping convenience is of paramount importance to the consumer, any claims that regional Bells would make about their entry into out-of-region long distance should be disregarded. A business model for out-of-region long-distance business could not be rationalized because then consumers would buy local and long-distance service from different providers.

Attempted consolidation between current local and long-distance providers is a distinct possibility. While some rightfully believe that such consolidation will lead us back to a "Ma Bell"-like situation — where efforts at long-distance competition could be thwarted — others undoubtedly will advance arguments in favor of this consolidation and against the assertion that such consolidation will substantially reduce competition in long-distance markets.

If confronted with a regional Bell and long-distance merger, antitrust authorities should review such arguments carefully to ensure that the competition in long-distance markets will be preserved.

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