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TELECOMMUNICATIONS MERGERS AND ACQUISITIONS: KEY POLICY ISSUES AND OPTIONS FOR STATE REGULATORS

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PREFACE

The goal of bringing the benefits of competition, including lower prices, higher quality, and greater innovation, to telecommunications consumers has resulted in the removal of many barriers to entry into telecommunications markets. As these barriers are removed, some firms may find it strategically desirable to enter new markets by merging, acquiring, or forming an alliance with a firm that already has a presence in that market.

This paper is one of a series of National Regulatory Research Institute (NRRI) papers on utility mergers and acquisitions. A previous paper in this series, *Mergers and Acquisitions: Guidelines for State Public Service Commissions* (NRRI 96-35), dealt with issues arising from mergers and acquisitions in the electric utility sector. This paper examines the issues arising from mergers, acquisitions, and alliances in the telecommunications sector.

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INTRODUCTION

The driving force in telecommunications regulation and policy is a desire (indeed an almost religious zeal) to bring the benefits of competition to formerly monopolized markets. The stated intent of the Telecommunications Act of 1996[1] was:

> To promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.

One major impact of the 1996 Act and its implementation by the FCC and state commissions is to eliminate the MFJ's line-of-business restrictions that had kept the Regional Bell Holding Companies (RHCs) from entering in-region inter-LATA markets and telephone equipment manufacturing. Also eliminated were restrictions that had kept AT&T from entering wireline local exchange markets.[2] Other restrictions were eliminated that prevented the RHCs and other local exchange companies (LECs) from providing local telephone service outside their franchised territories.

As a result, interexchange carriers (IXCs), such as AT&T, competitive access providers (CAPs), and cable system operators (CSOs) are allowed to offer local, intra-LATA, and inter-LATA telephone service to residential and business customers. In fact, any firm that can obtain certification from a state commission can offer local service through various combinations of its own facilities, unbundled network elements purchased from the incumbent LEC (ILEC), or resale of the ILEC's local service, which can be purchased from the LEC at a wholesale price. In addition, wireless service providers (cellular and PCS) are free to compete, and ILECs can offer service to

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[1] The Telecommunications Act of 1996 (Public Law 104-104, 110 Stat. 56, codified at 47 U.S.C. 151, *et seq.*) will also be referred to as "the 1996 Act."

[2] Although the RHCs have not, as yet, received authorization to offer in-region inter-LATA service, both Ameritech and SBC have requested such authorization under the provisions of Sec. 271 of the 1996 Act. The author assumes that, eventually, all the RHCs will be allowed to offer that service.

customers outside their traditional service areas.[3] RHCs, and others, can offer various enhanced or vertical telecommunications services (e.g., paging, voice mail, security services, and cable television). In addition, electric and gas utilities have formed "exempt telecommunications companies" under the provisions of Section 103 of the 1996 Act, which amends the Public Utility Holding Company Act of 1935 (PUHCA)[4] to allow them to offer telecommunications and information services under the FCC's jurisdiction.

The principal philosophy underlying reform of telecommunications regulation and policy at the federal and state levels is that consumers can be made better off by lowering or eliminating the barriers to entry in various telecommunications markets so that competition can develop. The desired result of pro-competitive policy[5] is that welfare will be enhanced because consumers will benefit from having a greater choice of providers, more service options, and lower prices. All of these are thought to flow from the competitive process. A central part of that philosophy is that, by opening local and interexchange markets to competitive entry, the existing market power of the incumbents in those markets will be eliminated, or at least substantially reduced.

As various telecommunications markets are opened to entry, some companies may choose to be niche providers, offering a narrow range of services. Other firms will implement a strategy that calls for them to offer "one-stop" shopping for all or most of a consumer's telecommunications, entertainment, and information services. Some firms that were once geographically constrained may adopt a strategy to expand beyond their former boundaries, becoming national and international providers. One way for a firm to enter new markets or expand its presence geographically is to merge with,

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[3] Although there are some restrictions on entry into markets served by rural LECs, the major metropolitan markets are open to competitive entry.

[4] The PUHCA is codified at 15 U.S.C. 79, *et seq.*

[5] A pro-competitive policy is one that affirmatively promotes and sustains competitive entry into a market. Such policies include requiring ILECs to interconnect with and offer unbundled network elements to entrants, allow entrants to use their rights-of-way facilities, and offer their retail service at wholesale rates to resellers.

acquire, or enter into joint ventures or strategic alliances[6] with firms already positioned in desirable or complementary locations or lines of business.[7] Indeed, entering new markets through merger, acquisition, joint venture or strategic alliance may be both less costly and less risky than *de novo* entry.[8]

A legitimate concern for regulators is the potential for mergers, acquisitions, and alliances to mitigate the desired effects of competition by enhancing the market power of firms that may operate in multiple product and geographic markets. Even ardent believers in the beneficial effects of competitive markets may find the prospect of the emergence of mega-firms troublesome. This paper briefly examines market power and market structure, discusses the possible effects of mergers, acquisitions, and alliances on market power, and considers some policy options for state regulators.

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[6] Mergers and acquisitions are methods of forming business combinations. In a merger, the assets and liabilities of two or more firms are combined into a single successor firm. In an acquisition, the acquiring firm uses some combination of cash, debt and equity securities to purchase the acquired firm. Although there are differences in legal, accounting, and tax treatment of mergers and acquisitions, for the purpose of this discussion, the term "merger" will be used to refer to either form of business combination. In a joint venture, two or more firms could purchase or establish a jointly owned entity, which could enter a specific market that is not served by its parents. In a strategic alliance, two or more firms could agree to market each others' products to their respective customers. A joint venture or strategic alliance does not result in a formal joining of the parent companies, although such relationships, if successful, could lead to the joining of the parents. In this discussion, the term "alliance" may refer to either a joint venture or a strategic alliance.

[7] Many firms are implementing strategies that would increase their presence in new geographic and/or product markets. This is sometimes referred to as increasing the firm's "footprint." Increasingly, firms feel the need to have a national or international footprint and to have a presence in multiple product markets.

[8] This may be part of the reasoning behind the merger discussions that recently took place between AT&T and SBC. Some discussion of such a merger is contained in the following sections.

MARKET POWER AND MARKET STRUCTURE[9]

Market Power

The term "market power" refers to a firm's ability to profit from maintaining the price of its product above competitive levels for a significant period of time. A firm is said to possess market power if, in the absence of price regulation, it would be profitable for it to hold the price of its product significantly above the competitive level (generally based on marginal cost) for some time. Market power may result from its output being "large" relative to the relevant market and/or as a result of there being few good substitutes for its product.[10] Firms with market power are "price makers,"[11] but they may also use their market power to control market characteristics on dimensions other than price, including quality, service, extent of product bundling, or rate of innovation.

Competitive and Contestable Markets

In a competitive market, firms are generally numerous and "small" in relation to the total size of the market, and the product is relatively homogeneous. In competitive markets, buyers have a number of independent sources of supply, and their ability to switch suppliers protects them from exploitation. In competitive markets, firms are "price takers" in the sense that no firm believes that it is able to affect the market price by altering its level of output. Few markets are fully competitive; nevertheless,

[9] For a more complete discussion of market structure and market power, see David Chessler, *Determining When Competition is "Workable": A Handbook for State Commissions Making Assessments Required by the Telecommunications Act of 1996* (Columbus, Ohio: The National Regulatory Research Institute, July 1996).

[10] The lack of good substitutes for a firm's product may result from there being few other producers of the product, or from other producers lacking the capacity to significantly increase their output. In economic terms, this means that the elasticity of supply of alternate producers is "low." However, even absent alternate sources of supply, a firm may not have exploitable market power if the market demand for its product has a "high" own-price elasticity.

[11] Although "market power" usually refers to the power of the seller to control prices, etc., large buyers can also have market power (called "monopsony power").

competitive markets are used as a standard to judge real-world markets. Moreover, some analysts have argued that low entry and exit barriers can result in a market behaving *as if* it were competitive even if only one or a few firms are in it. This is because the *threat* of competitive entry keeps sellers from exercising their market power. If potential competition acts to restrain the exercise of market power, markets are said to be "contestable." In a contestable market, there need not be large numbers of firms for reasonably efficient results to occur. However, just as few markets are fully competitive, few are fully contestable — because few markets are susceptible to "hit and run" entry.[12] In addition, the threat of regulatory or judicial action might also serve to limit the behavior of firms with market power.

Monopoly

A monopoly is a limiting case in which one firm controls the entire market. It must be noted that the existence of a monopoly is not, itself, illegal, For example, a monopoly may result from innovation — a firm may hold a patent that allows it to maintain a legally enforceable monopoly position on a product or process, or a monopoly could result from a firm being more efficient than its rivals. Nevertheless, it is illegal for a firm to engage in various practices or behaviors with the *intention* of

[12] The notion that contestable markets are capable of restraining the exercise of market power may be found in William J. Baumol, John C. Panzar, and Robert D. Willig, *Contestable Markets and the Theory of Industrial Structure*, rev. ed. (San Diego: Harcourt Brace Jovanovich, 1986). In order for the threat of entry to constrain the exercise of market power, the threatened entry must pass a test of being timely, likely, and sufficient. Potential entrants must be able to enter the market fairly quickly, so that consumers do not suffer great harm in the interim. Entry must be highly probable in the event the incumbent chooses to exploit its market power. And potential entry must be on a scale large enough to capture a significant portion of market from the incumbent.

creating a monopoly. In general, conscious attempts to monopolize a market are illegal under federal and state antitrust statutes.[13]

Monopoly Abuses

Practices that have been found to be *anticompetitive,* and thus illegal, include certain forms of price discrimination, tying the sale of one product to the purchase of another (leveraging a monopoly in one market to create a monopoly in a another market),[14] predatory pricing (pricing below cost in order to force rivals from the market),[15] establishing exclusionary practices such as vertical arrangements that exclude rivals from sources of raw materials or from distribution channels.[16]

It must be noted that predatory behavior is difficult to establish, and the courts have recently held that behavior appearing to be predatory can be within the bounds of vigorous competition. For example, a case involving possible predatory pricing in the

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[13] See, for example, Section 2 of the Sherman Act of 1890 (15 U.S.C. 2), which states that:

> Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any portion of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony . . .

With respect to mergers, Section 7 of the Clayton Act of 1914 (15 U.S.C. 18) further provides that:

> No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital . . . or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, . . . the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

[14] For example, until the 1970s LECs leveraged their monopoly in telephone service into the market for telephone customer premises equipment (CPE). Individual and business customers were not allowed to buy or rent phones or other terminal equipment from other vendors. It was not without some difficulty that requirements that customers obtain their telephone equipment from LECs were eliminated, allowing development of a competitive market for telephone CPE.

[15] Sometimes predatory pricing involves "selective" price reductions. A firm that wants to control a geographic market may cut prices only in that market in order to force rivals out or bring them into line. If such behavior can be shown to be intended to establish a local monopoly or dominance, it is illegal.

[16] Anticompetitive vertical behaviors include "refusal to deal." "Hypothetical" examples of refusals include a LEC that will purchase switches only from an affiliated manufacturer or provide access to its central offices only to an affiliated interexchange carrier. These sorts of vertical foreclosures led to the AT&T divestiture.

television set market[17] came before the United States Supreme Court. It was alleged that Japanese manufacturers had used profits from sales in their home market to finance a policy of below cost pricing in the U.S. market for the purpose of forcing U.S. manufacturers out of the market. Justice Powell, writing for the majority, observed that

> A predatory pricing conspiracy is, by nature, speculative. Any agreement to price below the competitive level requires the conspirators to forgo profits that free competition would offer them. The forgone profits may be considered an investment in the future. For the investment to be rational, the conspirators must have a reasonable expectation of recovering, in the form of later monopoly profits, more than the losses suffered.[18]

The Court's Opinion noted that the alleged predatory behavior had continued for a number of years without the plaintiffs being driven from the market, so that the alleged behavior was not rational. Thus, Justice Powell stated that:

> . . . cutting price in order to increase business is often the very essence of competition. Thus, mistaken inferences in [predatory-pricing cases] are especially costly, because they chill the very conduct the antitrust laws are designed to protect.[19]

Moreover, using similar reasoning, the Arkansas Supreme Court recently reversed a lower court finding of predatory pricing behavior by Wal-Mart Stores.[20] In that case, Wal-Mart was selling pharmaceuticals in Faulkner County, Arkansas, and its managers were allowed to lower prices in order to beat prices charged by rival pharmacies — even if such reductions brought Wal-Mart's retail prices below its own wholesale prices. Three local pharmacies filed a complaint against Wal-Mart for violating Arkansas's Unfair Trade Practices Act. This statute, enacted in 1937, prohibits selling or offering to sell any good or service

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[17] *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 1986.

[18] *Ibid*., at 588-89.

[19] *Ibid*., at 594.

[20] *Wal-Mart Stores, Inc. vs. American Drugs, Inc.* (891 S.W. 2d 30 1995).

> "at less than the cost thereof to the vendor . . . for the purpose of injuring competitors and destroying competition."[21]

In its Wal-Mart Opinion, the Arkansas Supreme Court cited the stated pro-competitive purpose of the Act and ruled that the lower court had improperly inferred predatory intent from Wal-Mart's aggressive pricing and promotional practices. In the high court's view, each of the facts used by the lower court to infer predatory intent was consistent with healthy competitive activity, and it, thus, rejected the plaintiffs' contention that Wal-Mart's tactics were predatory,

Remedies for Monopoly Abuses

One remedy for monopolies is antitrust actions by government agencies. Antitrust actions have led to restructuring, as in the classic 1911 case of Standard Oil of New Jersey, which was split into a number of separate companies. More recently, a Department of Justice antitrust suit led to AT&T divesting itself of its local telephone operating companies. Private antitrust suits, such as MCI's antitrust suit against AT&T,[22] may also provide remedies, and they can lead to damage awards. However, it must be noted that antitrust actions, whether by governmental or private parties, is a slow process.[23]

In cases where the monopoly results not from the practices of a firm but from the existence of economies of scale in production — so that total costs would rise if the monopoly were restructured — the monopolist can be constrained by regulation, which is intended to substitute for competition in situations where competition would not be efficient or sustainable.[24] Modern economic theory concludes that, when cost

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[21] Ark. Code Ann. §4-75-209(a)(1).

[22] See *MCI Communications Corp. v. American Telephone and Telegraph Co.*, 708 F. 2d 1081 (7th Cir., 1983).

[23] For some discussion of antitrust issues in the public utility sector may be found in Suedeen Kelly and Robert E. Burns, "The Antitrust State Action Doctrine and its Potential Role in Assuring Consumer Protection in a More Competitive Utility Environment," *NRRI Quarterly Bulletin* 17, n. 3 (Fall 1996), 395-411.

[24] This is the "natural monopoly" justification for public utility regulation.

conditions allow, it is preferable for a market to be lightly regulated and open to competitive entry rather than tightly regulated with entry foreclosed. Regulation has evolved various rules that constrain the behavior of monopolists. For example, when a firm is a monopolist in some markets but faces competition in others, regulation often requires that the firm's prices for competitive services be "subsidy free."[25] In addition, regulation has developed rules for non-discriminatory access and affiliate transactions to ensure that potential competitors are able to obtain access to bottleneck facilities on terms that make efficient competitive entry possible.

Oligopoly

Between competition and monopoly lies oligopoly, which signifies a market with few sellers. Just as some markets may be "natural monopolies," some may be "natural oligopolies" in the sense that some markets cannot support more than a few efficient producers.[26] In an oligopoly, individual firms are large enough to have some control over market price, and rivalry between firms may be more active and intense than under competition — which is characterized by anonymous rivalry. Under oligopoly, prices tend to be higher than under competition, and sellers may try to differentiate their products by advertising and using "brand names." Indeed, one of the differences between competition and oligopoly is the emphasis on advertising, brand names, and product differentiation.

Oligopolistic behavior may be thought of as a form of game in which players know each other, recognize their interdependence, and take each other's reactions into account when making a decision. Rivalry among oligopolists may be intense and, at

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[25] In this context, subsidy-free pricing requires that the firm must price its competitive services to recover at least the "cost" of providing them (generally based on some version of long-run incremental cost). In addition, if a firm provides unbundled wholesale services or elements to other firms, the prices of its retail service offerings must cover the imputed prices of the underlying unbundled services or elements.

[26] The technology of production and the size of market demand combine to determine how many efficient producers can exist. An efficient producer is able to operate at a level or scale of output such that average cost is minimized. This scale of operation is sometimes called the "minimum efficient scale."

times, painful. Thus, incentives for collusion may exist. Collusion is, of course, illegal, but it does happen — sometimes it is overt; at other times, it is covert or tacit — firms may develop a "don't rock the boat" or "live and let live" attitude. Both overt and tacit collusion are illegal.

Oligopolists may also use various unfair practices, including predatory or strategic pricing, to keep others out or drive rivals from the market. One form of strategic pricing is a "price war" in which prices are lowered to harm rivals or to bring them into line.

Oligopolists may also attempt to deter others from entering their market. This can be done by signaling potential rivals that they will defend the market. The willingness to invest in excess fixed capacity, spend money on advertising, control distribution channels, etc., are all ways of deterring entry, because these tend to make entry more costly.[27] The dominant firm may also try to control its rivals' costs — especially if it controls patents or essential facilities.[28] In addition, legal or administrative challenges may be used to deter entry. In telecommunications, some incumbents have a history of using the administrative and legal tactics to delay and limit entry.

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[27] Entry into markets controlled by established incumbents may be thought of analogous to invading a well-entrenched enemy. In order for an entrant to gain a sustainable beachhead in enemy territory, it must attract customers, and it can do so only by luring them away from the incumbents. The entrant must price below the incumbents, offer better quality of service, or offer customers some other reason to switch. The greater the incumbent's investment in excess capacity the more likely it may be to attempt to repel an entrant. And the greater the incumbent's spending on advertising or "brand-name capital" through advertising, the more resources the entrant must expend to establish a sustainable market share. Brand-name capital may be long-lived: AT&T is still identified by many as "the phone company," which may make its entry into local markets somewhat easier.

[28] For some discussion of the essential facilities doctrine, see Edwin A. Rosenberg and Stella Rubia, *Rights-of-Way and Other Customer-Access Facilities: Issues, Policies, and Options for Regulators* (Columbus, Ohio: The National Regulatory Research Institute, September 1996), 97-110; James E. Meeks, *Antitrust Concerns in the Modern Public Utility Environment* (Columbus, Ohio: The National Regulatory Research Institute, April 1996), 86-90; and Robert E. Burns, "Access to the Bottleneck: Legal Issues Regarding Electric Transmission and Natural Gas Distribution," in J. Stephen Henderson, ed. *Natural Gas Industry Restructuring Issues* (Columbus, Ohio: The National Regulatory Research Institute, September 1986), 31-70.

Telecommunications Market Structures

The structure of most telecommunications markets, at least over the near term, will be oligopoly rather than competition. Local exchange markets have been monopolies, and competitive entry is, at best, nascent. The inter-LATA market has been described as a tight oligopoly (with only three major facilities-based providers),[29] and local cellular markets are duopolies (two providers), although that will change as PCS license holders roll out services. In some oligopolies the dominant firm acts as the market leader, and there is a competitive fringe of smaller firms that act as followers, keeping their prices at or slightly below the leader's.[30] For example, the pricing behavior of MCI and Sprint has been described as following AT&T's leadership or operating under its price umbrella.

Without some control on its behavior, a market leader may drive the fringe out, or it may allow the fringe to operate in order not to arouse antitrust concerns. The possibility of this sort of behavior may be a rationale for the FCC's "dominant" carrier regulation of AT&T.[31] In addition, the differential rules placed on incumbent LECs by the 1996 Act and the unbundling, resale, interconnection, and nondiscriminatory access

[29] This will change as the RHCs obtain permission to offer in-region, inter-LATA toll service.

[30] Overt collusion to control prices constitutes an illegal restraint of trade under Section 1 of the Sherman Act. Tacit collusion is also illegal. Price leadership falls in a "gray" area, but the longer it persists, and the more it becomes "understood," the more likely it is to be considered tacit collusion and, thus, illegal.

[31] The FCC has concluded that it no longer needs to apply dominant carrier regulation to AT&T. As might be expected, AT&T's rivals appealed this action. It is interesting that it took over twelve years of competition in the IXC market before the FCC felt it was able to take this action. See FCC 95-427, *Order In the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier,* (Adopted October 12, 1995).

provisions contained in the 1996 Act and the FCC's implementation of it[32] recognize the potential market power of the incumbents and attempt to constrain abuse of that power.

[32] See, for example, FCC 96-325, *First Report and Order* in CC Docket 96-98, "In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996," and CC Docket 95-145, "Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers," (released August 8, 1996).

MERGERS AND MARKET POWER

The linkage between market power and market structure (and *vice versa*) has long been of interest to economists and policy makers. In general, many economists believe that the more a market is dominated by one or a few firms,[33] the less likely it will be to approach the competitive ideal.[34] A major concern is that a merger that increases market concentration may increase market power or facilitate its exercise, lessening the market's competitiveness. There are two ways in which a merger that increases market concentration can have deleterious effects. First, a merger that increases a firm's market may increase the firm's willingness and ability to engage in unilateral exercise of that power. Second, a merger that increases market concentration may increase the ability of a group of firms to engage in a multilateral or coordinated exercise of market power through either overt or tacit collusion or cooperation.[35] Responsibility and jurisdiction for reviewing proposed mergers, acquisitions, and alliances involving firms in the telecom sector is shared by the Securities and Exchange Commission, the Federal Trade Commission (FTC), the Antitrust Division of the Department of Justice, the Federal Communications Commission, and various state securities, antitrust, and regulatory bodies.

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[33] Commonly used measures of market dominance include concentration ratios (for example, the combined market share of the largest single firm or largest four firms in the market) and the Herfindahl-Hirschman Index (HHI), which is the sum of the squared market shares of all firms in the market.

The *Department of Justice and Federal Trade Commission Merger Guidelines* (issued April 2, 1992, and also referred to as the *"1992 Merger Guidelines*") defines three broad ranges of market concentration, as measured by the HHI. These are: "unconcentrated" — an HHI below 1000; "moderately concentrated" — an HHI between 1000 and 1800; and "highly concentrated" — an HHI greater than 1800. One implication of this classification is that a market would be classified as "highly concentrated," if the largest single firm's market share was 43% or more, and "moderately concentrated," if the largest single firm's market share was between 32% and 43%.

[34] This is the "structure-conduct-performance" paradigm that has long influenced industrial organization economics. It must be noted that considerable debate surrounds the empirical reliability of predictions derived from this paradigm.

[35] A merger may facilitate multilateral exercise of market power by reducing the number of firms, making it easier to coordinate behavior; or by tightening the oligopoly, making interdependence among rivals more obvious, making tacit cooperation more likely.

Mergers, acquisitions, and other business alliances (joint ventures, cross-marketing arrangements, etc.) can be categorized as:[36]

> ***Horizontal mergers*** — between firms providing the same or similar services or products to similar customers, possibly in different geographic markets — e.g., two LECs or two IXCs.
>
> ***Vertical mergers*** — between firms operating in different stages of the production / distribution process, where one firm might act as a supplier to the other — e.g., a LEC and an equipment manufacturer or an IXC and a LEC.
>
> ***Congeneric mergers*** — between firms operating in related markets that are neither directly vertically nor horizontally related. Instead, the linkage may be through similarities in production technology, customer base, or distribution channels — e.g., a LEC and a cellular provider or a LEC and an internet services provider.
>
> ***Conglomerate mergers*** — between firms providing products and services that are not closely related in production, distribution, or consumption — e.g., a LEC and a credit card issuer or a LEC and a CSO.

MERGERS — GOOD AND BAD

Mergers can allow firms to take advantage of economies of scale, scope, and/or coordination. Mergers among smaller firms can serve to "rationalize" a fragmented industry, which may create efficiencies. Nevertheless, mergers may serve to limit competition by creating greater market power. As noted above, mergers and other alliances can create the ability to offer consumers "one-stop shopping," and let a firm

[36] These examples are a bit arbitrary. That is, some combinations may not fit neatly into one of the categories. The categorization might depend on the closeness of the two firms' primary Standard Industrial Classification (SIC) codes or the new North American Industrial Classification System (NAICS) codes. Horizontal mergers involve firms in the same 4-digit SIC code or 5-digit NAICS code. Firms sharing a 3-digit SIC code or a 4-digit NAICS code could represent a vertical or congeneric merger. Firms that share 2-digit codes could represent vertical, congeneric, or conglomerate mergers. Firms that do not share at least a 2-digit code would most likely be involved in a conglomerate merger (assuming that one did not manufacture raw materials or market finished goods for the other, in which case it would be a vertical merger).

enter a market more easily than if it had to do so on its own.[37] Some firms may find it useful to merge or form alliances rather than compete with one another, and they may find that the combined firm serves to make some potential competitors wary of entering their turf.

The Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission have recognized the potential for mergers to enhance efficiency. Recently, these agencies jointly issued a policy statement, *Revision to the Horizontal Merger Guidelines,*[38] that considers these issues. The *Revision* says, in part:

> . . . mergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to generate such efficiencies. . . . merger-generated efficiencies may enhance competition by permitting two ineffective (e.g., high cost) competitors to become one effective (e.g., lower cost) competitor. . . . cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm. . . . cost reductions may reduce the merged firm's incentive to elevate price. Efficiencies also may result in benefits in the form of new or improved products, and efficiencies may result in benefits even when price is not immediately and directly affected.

However, the *Revision* also notes that:

> Even when efficiencies generated through merger enhance a firm's ability to compete, however, a merger may have other effects that may lessen competition and ultimately may make the merger anticompetitive.

And it was further observe that:

> Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the

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[37] Entry by merger may be easier, because the merged firm has name recognition, a customer base, and human capital that might take considerable time to develop. Entry by merger may also be preferable when entry is risky and entails considerable sunk costs. The adage that it is better to join than fight may apply to the choice of entering a market through merger rather than through independent entry.

[38] Issued April 8, 1997.

> merging firms. Moreover, efficiencies projected reasonably and in good faith by the merging firms may not be realized.

The *Revisions* further state that:

> The greater the potential adverse competitive effect of a merger . . . the greater must be cognizable efficiencies[39] . . . to conclude that the merger will not have an anticompetitive effect . . . efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great. <u>Efficiencies almost never justify a merger to monopoly or near-monopoly</u>. [Emphasis added.]

One reason for recent merger activity is the prospect of competition in formerly monopolized sectors and the rise of incentive regulation. Both of these may lead small, high-cost producers to seek to merge in order to reduce costs. In addition, incentive regulation creates positive incentives for efficiency, as the firm can retain all or part of the savings. The threat of competition also creates important incentives for efficiency (cut costs or die!) and serves to make some players want to increase their market presence — some analysts believe that larger firms have a greater chance of survival.[40] However, there is little evidence that mergers between truly large firms produce significant economies of scale or scope. Economies can result from mergers of large players only if the successor firm is better managed than one or either of the predecessors and if the cultures of the two firms can be combined in a way that facilitates efficiency.[41]

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[39] "Cognizable efficiencies" are defined in the *Revision* as "merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service." They are considered to be "net of costs produced by the merger or incurred in achieving those efficiencies."

[40] This is called the "get big or die" view. One rationale comes from seeing the world as one large market, so that firms that appear large in a local sense look small in a global sense. It remains to be seen whether this view is correct. Indeed, it may be the case that, like politics, competition and market power are local.

[41] Some conglomerate mergers of the 1970s and 1980s, which promised to produce great "synergies," did not achieve the results predicted. This may be due to the difficulties in effectively coordinating dissimilar operations, which may have very different cultures and require different talents. As a result, in the late 1980s and early 1990s some conglomerates sold off prior acquisitions in order to concentrate their resources on their "core" competencies or markets.

MERGERS — REGULATORY ISSUES

Regulatory issues surrounding mergers include how consumers will benefit as a result and the effect of the merger on competition. The major themes of merger policy is that consumers should be at least as well off as a result of the merger, and that mergers should not be permitted to create significant market power, enhance existing market power, or facilitate its exercise. Mergers should not be allowed to hinder competition by creating impenetrable fortresses of market power. If the goal of telecommunications reform is to promote competition, mergers that combine likely competitors should be considered suspect. Firms should not be allowed to remove potential competitors by merging with them. Often the merging firms claim that there are significant cost savings or other benefits flowing from combining their business operations. If such costs savings or other efficiencies result, consumers should get a share.

Other merger-related regulatory issues include those that are not related to the effect of the merger on the competitiveness of the market. These public interest issues include the effect on jobs and investment within a state, the financial health and quality of management of the merged company, the effect on employees, the new entity's ability and willingness to respond to customer needs, and the potential impact on the state commission's ability to regulate the new entity. A useful set of issues for state regulators to consider can be found in *Section 854 of California's Pubic Utilities Code*. That Section requires the Commission to find that the merger does the following:

(1) Provides short-term and long-term economic benefits to ratepayers.

(2) Equitably allocates benefits so that ratepayers receive at least half of them.

(3) Not adversely affect competition. If so, the Commission is required to adopt measures to mitigate the adverse affect.

In addition to requiring that these three items be met, California's *Section 854* requires the Commission to find that, on balance, the merger would be in the public interest based on consideration of the extent to which it would:

(1) Maintain or improve the financial condition of the resulting public utility doing business in the state.

(2) Maintain or improve the quality of service to public utility ratepayers in the state.

(3) Maintain or improve the quality of management of the resulting public utility doing business in the state.

(4) Be fair and reasonable to affected public utility employees, including both union and nonunion employees.

(5) Be fair and reasonable to the majority of all public utility shareholders.

(6) Be beneficial on an overall basis to state and local economies, and to the communities in the area served by the resulting public utility.

(7) Preserve the jurisdiction of the commission and the capacity of the commission to effectively regulate and audit public utility operations in the state.

(8) Provide mitigation measures to prevent significant adverse consequences which may result.

Although not related to issues of competitiveness, a merger between major companies will result in one state losing a corporate headquarters and the attendant jobs. This will impact the state and local economy, and, in the state approvals of both the PacTel/SBC and the Bell Atlantic/NYNEX mergers, the effect on jobs in the various states became a significant issue. As a result, both California and New York were given assurances regarding levels of continued employment in their states. In addition, state regulators won consumer benefits in the form of rebates (California) and investments in service quality upgrades (New York).

Another concern for state regulators is the ability and willingness of the merged firm to respond to both the state's consumers and regulators. Responsiveness is a genuine issue. State regulators should ensure that the merged company will be appropriately responsive both to them and to consumers in their state. The possibility that the merged firm will not be as responsive can result not only from intent or design but from being part of a larger entity, which may require that decisions be made at a greater distance than was previously the case. After a merger, state-level executives may be unable to make decisions, offer commitments, or provide information on a timely basis. State regulators also need to ensure that the merged entity will be at least as well managed and financed as the pre-merged firm under its jurisdiction.

DIVESTITURES AND SPINOFFS

Sometimes a firm divests itself of certain properties or operations by selling them to another firm or spinning the operations off as an independent firm. These actions may also cause concern. Examples include PacTel spinning off Airtouch (its wireless operations), U S WEST selling rural exchanges in several states, and the recently announced sale of U S WEST's wireless operations to Airtouch. Care must be taken to ensure that, unless and until there are genuine alternative sources of supply, customers are not harmed as a result.

Another recent divestiture or spinoff is AT&T's spinning off of its manufacturing operations as a separate firm, which was renamed, "Lucent Technologies." One possible reason for this spinoff was to overcome reluctance on the part of the RHCs to deal with a subsidiary of AT&T (with whom they likely will be competing in both local and toll markets). Lucent may have a better chance to obtain the RHCs' equipment business as an independent company than as part of AT&T.

In addition to divestitures and spinoffs, some RHCs and other holding companies are selling or swapping exchanges in apparent efforts to consolidate their service area boundaries. Such a transaction involves Sprint's recently announced sale of some of its operations, which serve 136,000 access lines in the Chicago, Illinois area.[42] There may be genuine business reasons for such moves, and, if the sale is to a stronger or more efficient firm, consumers may benefit, but such sales could also

[42] See "Ameritech Agrees to Buy Sprint's Access Lines in Chicago Area," *Telecommunications Reports* 63, n. 15 (April 14, 1997): 16.

evidence a strategy of firms pulling out of areas where their market presence is not strong in order to avoid competitive confrontations.

AFFILIATE TRANSACTIONS

One concern that results from vertical or congeneric mergers is that the competitiveness of upstream, downstream, or related markets will be affected. Such effects could result if affiliated firms are given preferential treatment relative to unaffiliated firms. This problem has long been known, since regulated firms often have unregulated subsidiaries or affiliates under the umbrella of a holding company.

Traditional regulatory concerns have been that the unregulated subsidiary or affiliate would be used to shift costs to or profits from the regulated businesses. These concerns have been addressed by imposing various account separations rules, structural separations rules, and affiliate transactions rules. New, but related, concerns involve the possible use of unregulated subsidiaries or affiliates to thwart competition by giving them favorable treatment. State and federal commissions have been developing various nondiscriminatory rules to limit this, but the issue will undoubtedly arise, as potential competitors will argue that affiliates are favored.[43]

Clearly, the nondiscrimination rules regarding treatment of competitors relative to affiliated firms, as evidenced in the FCC's *Interconnection Order,* impose "treat your competitor as yourself" or "Golden Rule" obligations on ILECs with respect to treatment of affiliates relative to others.[44] In general, ILECs must offer any firm providing telecommunications services the same terms, conditions, and pricing as it gives itself or its affiliates. The FCC even interpreted the nondiscrimination principle as requiring the

[43] For example, the Public Utilities Commission of Ohio (PUCO) recently found that Ameritech-Ohio's pole attachment practices and charges discriminated in favor of its cable television affiliate, New Media, Inc. The PUCO found that New Media was given preferential treatment in the placement of its attachments on Ameritech-owned poles. This treatment discriminated against New Media''s unaffiliated competitors. See PUCO, *Order* in Case No. 96-1027-TP-CSS (issued April 17, 1997).

[44] FCC 96-325, cited in note 32, above.

ILEC to expand its rights-of-way facilities or use its own eminent domain power to create rights-of-way access for entrants.[45]

TELECOM SECTOR MERGERS

The removal of barriers to entry into telecommunications markets has led to a number of mergers between major players, and there is some concern about the effect of mergers on competition in telecommunications. Horizontal mergers include those between Pacific Telesis and SBC and between Bell Atlantic and NYNEX. Such mergers may cause concern even though the partners did not have a history of competition. This is because a merger may result in lessened threat of competition, especially when they were positioned to become competitors.[46]

This consideration was more apparent in the case of the Bell Atlantic/NYNEX merger than in the case of PacTel/SBC. Between them, Bell Atlantic and NYNEX dominate the local exchange market from Virginia to Maine (with the exception of

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[45] *Ibid*., paras. 1180-1181. See also the discussion in Rosenberg and Rubia, *Rights-of-Way and Other Customer-Access Facilities,* 77-90.

[46] Suppose that firms A and B propose to merge and that they had not historically been, but could become, competitors — that is, they are "actual potential competitors." Further suppose that B's market is "concentrated" and that B has market power. Analysis of the effect of a merger between such actual potential competitors requires developing answers to several sequential questions, including:

> If there is no merger, how likely is it that A will enter B's market by itself or in combination with another firm or with an existing competitor in B's market.
>
> What special advantages would A have to assist it in entering B's market?
>
> How successful is A likely to be if it enters B's market?
>
> Would A's entry into B's market reduce concentration and be procompetitive in B's market?
>
> if the merger is allowed, so that A does not enter B's market, how likely is it that another firm will enter B's market with equivalent success?

Answers to the above questions depend on a number of assumptions and extrapolations, and there may be a range of possible answers. Nevertheless, these questions should be considered when evaluating a merger between firms that could compete but have not done so, possibly because of historic restrictions or barriers to competition. Moreover, if A operates in a concentrated market, the effect of the loss of B as an actual potential competitor in A's market should be considered, as well.

Connecticut, which is served by Southern New England Telephone Co.). Their service territories border each other, and they each serve parts of the highly desirable telecommunications markets in the "BoWash" corridor. At first glance, notwithstanding the companies' representations that they had no plans to enter each other's markets, it is easy to think that this merger has had the effect of removing at least one competitive threat from each market. Of course, major parts of the Bell Atlantic/NYNEX's service area are still extremely attractive to entrants, but now entrants will be facing an even larger incumbent — which has removed an actual potential competitor through merger.

The PacTel/SBC merger did not raise concerns to the same extent as did the Bell Atlantic/NYNEX combination. Separated by U S WEST, the two firms were non-contiguous, and although it was not unthinkable that they would compete, It was not as likely that they would do so, and each firm has other potential competitors to worry about. What started as seven RHCs is now down to five. Is a combination involving two of Ameritech, BellSouth, and U S WEST unthinkable? Having approved the PacTel/SBC and Bell Atlantic/NYNEX mergers, would state and federal regulators do likewise for an Ameritech/BellSouth combination?

Vertical mergers such as AT&T and McCaw Cellular may increase competition in some markets to the extent that the merged firm is a stronger and more national presence. Conglomerate mergers such as that of US West and TCI, a cable systems operator, and that of GTE and BNN, an internet service provider, may cause concern.[47] Other mergers include the merger of MCI and British Telephone to form Concert,[48] and the recently considered possibility of a merger between AT&T and SBC.

Even the possibility of a merger between AT&T and SBC (or with another RHC) has certainly raised concerns. Indeed, FCC Chairman Reed Hundt voiced his own

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[47] The GTE/BBN merger or acquisition may also be considered as a congeneric or vertical merger.

[48] The merger of MCI and BT raised few concerns. This is possibly because an alliance with BT can provide MCI with the resources to increase its presence in local markets and remain competitive as the RHCs enter inter-LATA markets.

personal belief that a merger between the largest IXC and an RHC would be unthinkable and not in the public interest.[49] Mr. Hundt observed that:

> Under the statutory authority granted to FCC in sections 214 and 310 of the Communications Act, as well as under the Commission's authority to enforce Section 7 of the Clayton Act with respect to combinations of common carriers, the FCC would eventually be obliged to pass judgment upon any such merger.

He further stated that:

> If certain forms of cooperation are going to be out of bounds for some firms in some markets, we need those firms to devote their zealous energy and precious resources to the push for fair, pro-competitive rules and real entry in all telecommunications markets, rather than to be encouraged to spend their time trying to accomplish an unthinkable combination.

Mr. Hundt’s concern about the effects of an AT&T merger with SBC (or indeed with any RHC) flows from his observation that:

> AT&T is currently present in the same geographic markets as each and every [RHC]. In each [RHC] region, the Bell and AT&T offer service to the same customers. They have parallel and not wholly dissimilar facilities. They often have parallel billing systems. They have brand name recognition and marketing capability with respect to the same customers. They are what ought to be called "precluded competitors" — that is, firms that naturally would compete with each other, and that have not competed only because they have been precluded from doing so by law and by the absence of enforceable procompetitive rules. In fact, these particular precluded competitors have sought the legal rights and legal capabilities to compete with each other.

Mr. Hundt offered an analogy and said that:

> . . . providing local exchange service is like being a bran merchant and offering long distance is like being a vendor of raisins. The goal of the Telecom Act was to get the raisin merchants into the bran business, the bran sellers into the raisin business and everyone into the raisin bran business — that is, bundled telecom services.

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[49] Reed E. Hundt, “Thinking About Why Some Communications Mergers are Unthinkable,” presented at the Brookings Institution, Washington, D.C., June 19, 1997.

He further said that:

> When we evaluate mergers in communications markets, we need to determine whether the parties in question fall into the category of competitors that have been precluded from entering a market. It may aid clarity of thought to call firms precluded competitors instead of potential competitors when law, or the lack of pro-competitive rules, not inclination or capability, is the reason they have not yet become actual competitors. In any event, under potential competition theory and under our newly named "precluded competition" theory, the result is essentially the same: an AT&T-[RHC] merger is not thinkable.

In Mr. Hundt's view, AT&T's strong position in the in-region inter-LATA market, SBC's dominance in its regional local exchange and intra-LATA markets, and the fact that each had indicated a desire and willingness to enter the other's market and compete for the same customers' business, leads him to view the *pro forma* results of a combination between the two as not being good for competition.[50] The fact that SBC collects about 60% of telecommunications spending in its region and AT&T collects another 20% implies that the combination would imply an unacceptable degree of multi-market concentration.

Mr. Hundt was almost equally concerned about "out-of-region" cooperation between AT&T and an RHC. He was concerned about what he termed "risky 'spillover' effects," which would make it difficult for AT&T and the RHC to develop and share business secrets and strategies for use in their out-of-region cooperative ventures while competing vigorously with each other for in-region local and toll business. An inference may be drawn that out-of-region cooperation may lead to the development of common interests that result in or facilitate some form of tacit in-region cooperation. This is an important concern, and it should not be minimized. Firms that have common interests in some markets may find it useful not to slug it out too hard in other markets.

Mr. Hundt did not discuss it, and no one has proposed it, but the question of a combination of AT&T and a non-RHC LEC holding company, such as GTE, may raise similar but lessened concerns. Although GTE's local operations are spread over most

[50] The same could be said for a merger between AT&T and any of the RHCs.

of the states, they do not dominate areas that are as large as the RHCs, and GTE may be more vulnerable in a competitive market. A merger involving an RHC and one of the smaller IXCs would also arouse lessened concern. Also, mergers between smaller players are not likely to raise much concern and may create more effective competition. And mergers that do not result in a significant increase in market concentration or create a concentrated market do not require further analysis.[51]

A wave of mergers could create a few huge players in the converging telecom / entertainment / information market, and inhibit additional entry. Instead of competition, we could end up with fairly tight or dominant firm oligopolies in the combined markets. Oligopolists might choose “silent” cooperation rather than hard competition, and that would not be good for consumers. Certain hypothetical mergers (between AT&T and another IXC, for example) would almost certainly meet with opposition, and the Antitrust Division of the Justice Department has indicated that it will look closely at telecom mergers, but state regulators may also be legitimately concerned: nobody wants to see a new version of the old Bell System rising phoenix-like to stamp out the fires of competition.[52] In addition, Senator Robert Kerry of Nebraska has introduced legislation that would require the Justice Department to oppose any telecom merger that did not “significantly enhance competition.”[53] If enacted, such legislation would essentially reverse the burden of proof in telecom merger analysis at the federal level.

Ironically, the furor created by discussions of a possible merger between AT&T and SBC may be pro-competitive if it leads AT&T to put more effort into facilities-based

[51] These include recently announced mergers between Century Telephone Enterprises and Pacific Telecom to form the 12th largest LEC and 10th largest cellular carrier in the nation (See “Century Telephone to Acquire Pacific Telecom for $1.5B Cash,” *Telecommunications Reports* 63, n. 23 (June 16, 1997): 12-13) and between two CLECs, McLeod USA and Consolidated Communications to form a “super-regional” CLEC serving 14 contiguous states from Indiana to Utah (See Beth Snyder, “McCloud merger is simply super,” *Telephony*, June 23, 1997, 7).

[52] Even a merger between AT&T and another IXC would not be unthinkable, especially if, after RHC entry into the in-region inter-LATA market, AT&T appears to be rescuing a failing firm. Acquisition of a failing firm, even by the market leader, almost never arouses concerns — because the combined firm is not likely to have greater market power than the market leader by itself.

[53] See “Kerry Wants Stiffer Telecom Antitrust Merger Reviews,” *Telecommunications Reports* 63, n. 24 (June 30, 1997): 7.

entry into local markets — possibly through expedited roll-out of its wireless local loop technology.

OTHER ALLIANCES

Other business combinations include joint ventures and cross-marketing arrangements.[54] To the extent that these raise concerns about potential for anticompetitive abuses, they should be examined carefully. For example, customers should be clearly informed that, although they may do so if it is in their interest, they are under no obligation to purchase multiple services from a single provider or marketer. In addition care must be taken to ensure that no favorable discrimination is given to firms involved in such joint marketing arrangements — i.e., that the partners in joint or cross-marketing arrangements do not give each other more favorable terms than they would other potential resellers or remarketers of their services. Moreover, to echo FCC Chairman Reed Hundt's concern, joint ventures, especially between or among firms that might otherwise be likely to compete head-to-head with one another in some markets (between a LEC and an IXC, for example), may be a market coordination device that tends to limit real competition.

[54] For example, it was recently announced that AT&T was joining with UtiliCorp United, Inc. and Peco Energy Co. in a joint venture named "EnergyOne" to offer natural gas, electricity, telephone, Internet, and home security services in a single package. Customers would receive an integrated bill for all these services. Such joint- or cross-marketing arrangements allow, say, an electric or gas utility, which already has entrée into a customer's home or business to market telephone services provided by AT&T. Similar arrangements, including franchising of various utility and telecommunications services, are being developed by other groups. See "'Growth Cowboys' Ride Herd Over One-Stop Utilities," *The Columbus Dispatch,* June 25, 1997, 2f.

The Special Problem of Infrastructure Sharing[55]

Section 259 of the 1996 Act requires incumbent LECs to share infrastructure with any qualified carrier.[56] In particular, the ILEC is required to make available public switched network infrastructure, technology, information, and telecommunications facilities and functions to enable the qualified carriers to provide telecommunications services or provide access to information services in the service area where the qualifying carrier is designated as an "eligible telecommunications carrier."[57]

Section 259 also provides that, after a local exchange carrier has entered into an infrastructure sharing agreement, it will inform each party to the agreement in a timely fashion about planned deployment of telecommunications services and equipment, including any software or upgrades of software that may be integral to the use or operation of telecommunications equipment subject to the infrastructure sharing agreement.

A potential problem might exist if the capacity of the public switched network infrastructure, technology, information, or telecommunications facilities and functions that might be requested by a qualified carrier is limited. In such circumstances, the FCC and/or state commissions might find it necessary to allocate the availability of the limited facilities or functions. Otherwise, qualified carriers' use of essential facilities might preclude and foreclose the use of the facilities by other potential entrants, some of whom may also be qualified carriers.

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[55] The discussion of the infrastructure sharing provisions in Section 259 of the 1996 Act was authored by NRRI Senior Research Specialist, Robert E. Burns.

[56] A qualifying carrier here means a telecommunications carrier that (1) lacks economies of scale or scope, as prescribed in the FCC's regulations, and (2) offers telephone exchange service, exchange access, and any other service included in universal service, to all consumers, without preference, throughout the service area for which it has been designated as an eligible telecommunications carrier.

[57] An "eligible telecommunications carrier" is defined in Sec. 214 (e) of the 1996 Act as a common carrier that is designated by a state commission as being eligible to receive federal universal service support in a service area. It must offer the package of federally supported services using its own facilities or through resale, and it must advertise the availability of those services.

If infrastructure sharing is implemented in a way that allows limited facilities and functions to be made available on a first-come, first-served basis, a new barrier to market entry may be created. Even use of a secondary market (i.e., resale of shared infrastructure) in such a circumstance would not remove the barrier. Instead, it would merely transfer rents from the ILEC to the qualified carrier that had secured the sharing arrangement.

Section 259 also sets out the terms and conditions for regulations concerning infrastructure sharing. For example, regulations may not require a ILEC to take any action that is economically unreasonable or contrary to the public interest. Elsewhere, Section 257 of the 1996 Act requires the FCC to identify and eliminate market entry barriers for entrepreneurs and other small business that provide or own telecommunications services or information services. Certainly, this provision should be read conjunction with Section 259 so that regulations adopted under 259 do not, themselves, become a barrier to subsequent entrants who need infrastructure sharing and come after the first wave of entrants. It could be argued it would be both economically unreasonable and contrary to the public interest to simply reward the first mover. This would particularly be the case if the qualifying carrier were in any way associated, through a joint venture or some other business alliance, with a LEC or some other similar entity.

Other potential anticompetitive problems could arise because of other terms and conditions the FCC is required to prescribe in regulations. For example, Section 259 (b) (2) requires the FCC to permit, but not require, the joint ownership or operation of the public switched network infrastructure and services between or among the local exchange carrier and a qualified carrier. In addition, Section 259 (b) (5) requires the FCC to establish conditions that promote cooperation between local exchange carriers and qualifying carriers. Although it may make sense to require joint ownership of public switched network infrastructure and services and encourage cooperation between carriers — particularly in circumstances where the available services and/or facilities are constrained and the qualified carrier is investing to expand available capacity —

there is some question as to whether it makes sense to encourage cooperation between potential competitors other than for necessary operational purposes.

The LEC would probably be the principal competitor of the qualifying carrier, and too cozy a relationship could lead to less than robust competition on prices, services, and quality. The FCC is required in Section 259 (b) (4) to ensure that LECs makes available their infrastructure, technology, information, facilities, or functions to qualified carriers on just and reasonable terms and conditions so that qualified carriers benefit fully from the LECs' economies of scale and scope. At the same time, under Section 259 (b) (6), the local exchange carrier is not required to enter into any infrastructure sharing agreement for any services or access that the qualified carrier provides or offers to consumers in the LEC's telephone exchange area. Thus, an ILEC would seem to be free to refuse to share facilities that would allow the qualified carrier to compete directly for the LEC's own customers in its local telephone exchange area.

Some of these provisions seem contradictory and poorly thought-out. State commissions might seek to ensure that the interest of consumers in having robust competition is properly balanced against the need of carriers to cooperate for operational and infrastructure sharing purposes. State commissions can make consumer welfare their foremost concern, and write regulations so that no barriers of entry are created by qualified carriers that are simply first movers, and that competition is encouraged.

RECOMMENDATIONS

Because barriers to entry and competition in telecommunications markets have been lowered, consumers have a desire for "one-stop" shopping, and it is often easier to enter a market through merger than as a startup, state commissions will be confronted with requests for approval of mergers between various telecommunications providers.[58] The goal of a merger policy should not be to inhibit mergers. Rather, the goal should be to ensure that the public interest is served and that there are no anticompetitive results.

There are a number of steps state commissions can take to ensure that mergers are in the public interest, or at least that they do not *reduce* competitiveness of the markets involved. It must be noted that some traditional measures of market structure may not be immediately useful in analyzing telecommunications markets, since those markets are moving from being either previously foreclosed to entry or tight oligopolies to being open to entry, and competition is in an emerging state.[59] Other factors that must be considered in analyzing market structure/power issues include the conditions of entry into the market (is it easy or difficult), the response of incumbents to entry, and the nature of demand for the product (a high demand elasticity, by itself, would limit the exercise of market power).

Because entry is only beginning in these markets, it is too early to draw firm conclusions.[60] FCC Chairman Hundt's analysis — a multi-market approximation of the

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[58] It appears that almost every state commission is required to approve mergers, consolidations, or the purchase or sale of facilities — including entire operating units. See *Utility Regulatory Policy in the United States and Canada: Compilation 1995-1996* (Washington, D.C.: The National Association of Regulatory Utility Commissioners, 1996), tables 32 and 33, pp. 91-94.

[59] Traditional measures of market structure (and thus market power) including concentration ratios and Herfindahl-Hirschman indices have been proposed. See Robert J. Graniere and Robert E. Burns, *Mergers and Acquisitions: Guidelines for Consideration by State Public Utility Commissions* (Columbus, Ohio: The National Regulatory Research Institute, November 1996) and Chessler, *Determining When Competition is* Workable, 17-27 and 55-84.

There are difficulties associated with using these traditional measures. First we're dealing with markets that have not historically been competitive. Second, definition of the market to be studied is not easy, since markets are defined both in terms of geography and product characteristics, and, as geographic and line-of-business boundaries are removed, the definition of telecommunications markets must be adjusted.

The *1992 Merger Guidelines* define a "market" as a product or group of products and a geographic area in which they are sold, such that a hypothetical profit-maximizing monopolist that controlled all such production (and is not subject to rate of return or price regulation) would raise price a small but significant amount, usually taken to be 5%, for some time. Mergers that increase the merged firm's ability to maintain a price increase of at least 5% in a market so-defined may be opposed.

[60] Telephone equipment markets (switchgear or CPE) might be analyzed using structural measures, but most telephone service markets cannot be analyzed with those tools.

regional market structure resulting from a merger of AT&T and SBC — is interesting. Indeed, because the LECs, IXCs, and others have evolved along parallel but separate lines, consideration must be given to the ability of a merged firm to dominate multiple linked markets.[61] In the future, when there are a number of established firms in the various geographic/product markets, traditional tools might be applied. At present, however, almost all telecommunications markets would be viewed as highly concentrated, thus subject to abusive exercise of market power. Indeed, it is the *assumption* of substantial market power that leads to the existence of state and federal regulators. Moreover, the imposition of various resale, unbundling, and non-discriminatory access rules by these regulators have been necessary to constrain the exercise of assumed market power.

States concerned about the effects of a proposed merger should take action *prior* to its consummation. Placing conditions on the merger will be more easily accomplished before the fact than after. And, once completed, a merger that proves to reduce competition may be difficult, if not impossible, to undo. States really have one opportunity to consider these issues, and that opportunity comes prior to granting approval. Whatever conditions or concessions a state commission wants to put in place are much better accomplished before the fact than after.

The provisions of California's Public Utilities Code[62] regarding factors commissions should consider are very useful in the sense that they allow for mitigating conditions to be imposed. Indeed, the imposition of conditions is common in merger approval, and such mitigating conditions might involve imposing structural separations between the operations of the merged firms or requiring that some of the merged firms operations be divested.[63]

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[61] Because barriers between individual markets have been removed, markets that might have been considered to be congeneric or vertical may be combining into single markets. For example, much of the distinctions between local telephone markets, intra-LATA markets, and inter-LATA markets may diminish to the point that there is only one telephone market. Similarly, the distinction between wireless and wireline markets may also diminish.

[62] These provisions were discussed above.

[63] This was done in some cable-telco mergers.

In addition to being concerned about competitive issues, state commissions may find it useful to impose public interest conditions on the merged company to ensure that it will be responsive to the state's regulators and consumers. This means that executives at the state level must be willing and able to appropriately respond to state regulators' concerns and that consumers continue to be well served .

State commissions need strong non-discrimination and affiliate transactions rules to ensure that a merger does not hinder competition in horizontal, congeneric, or vertical markets. Moreover, because the benefits of competition can flow to consumers only if it entry is real, sustainable, and vigorous, commissions may want to plan for ongoing review and monitoring of competitive conditions (rate, sustainability, and vigor of entry and competition) in their states. State commissions should engage in ongoing monitoring because traditional antitrust action deals only with things that have already occurred, and it is an excruciatingly slow process. Moreover, state commissions have ongoing jurisdiction and expertise in the area.

There are a number of things state regulators can do to prepare for these requests. They include:

(1) Announce the criteria upon which mergers will be evaluated in advance.

This includes announcing the types of mergers that would raise the most concern — for example, a merger of an RHC and another LEC in the state or the merger of a "formerly dominant" IXC and an RHC. Mergers might elicit less concern if they are between two smaller LECs or between a LEC and an Internet service provider.

(2) Apply the criteria prior to the merger.

Place conditions on the merger and require concessions as necessary to ensure that post-merger conditions do not harm either consumers or hinder competition in the state. It may prove easier to impose conditions and require concessions prior to and as a condition for approving the merger than to take corrective action after the merger.

(3) Consider the structure and entry conditions in the principal markets served by the merger partners.

If the partners do not dominate their markets, and entry into each market is relatively easy, then the merger should be of less concern. Conversely, if each firm dominates its market and entry is difficult, the merger should be of more concern.

(4) Consider conditioning approval for mergers involving BOCs on findings that the BOC's local and intra-LATA markets have been opened to competition.

For example, the BOC could be required to meet the "checklist" conditions in Section 271 of the 1996 Act.

(5) In evaluating mergers involving dominant firms, consider the dominant firm's historical behavior towards entrants and other competitors. Be especially concerned if a dominant firm has a history of attempting to impede or delay entry.

(6) Ensure that consumer choice is not diminished.

Perceptions of economies of scale and scope and consumer preference surveys that indicate a desire for "one-stop" shopping for telecommunications services may be one of the driving forces leading to mergers. Nevertheless, consumer choice can be preserved and enhanced if post-merger "one-stop" providers are required — on an ongoing basis — to inform consumers that they have options for obtaining services from various firms on a "mix-and-match" basis. This is especially true if the merger involves the ILEC and if the merger takes place prior to the growth of significant competition in the local exchange market.

(7) In analysis of joint ventures and strategic alliances, ensure that exclusive arrangements do not result in favorable treatment of alliance partners that result in anticompetitive discrimination.

(8) Be especially concerned about mergers that involve firms that would otherwise be expected to become competitors.

Mergers that appear to eliminate actual potential competitors (or "precluded" competitors, to use Reed Hundt's phrase) should be considered suspect. If such mergers are allowed, special consideration should be given to imposing even stricter procompetitive network access requirements.[64]

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[64] The merger talks between AT&T and SBC apparently broke apart as a result of AT&T's insistence that SBC boldly open its local networks to competitors, possibly by structurally separating or dividing itself into a wholesale network or platform provider and a retail service provider. It might be

(9) When telecommunications markets become more competitive, be prepared to use the more traditional market structure measures (concentration ratios and Herfindahl-Hirschman Indices) in merger evaluations.[65]

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inferred that AT&T believed that the only way such a merger could possibly be approved was to take such a step. It is not clear whether such separations would be enough, especially if the wholesale and retail operations are still under common ownership.

[65] Forthcoming analysis by the NRRI will address the problem of adapting existing measures or developing new measures to evaluate mergers in markets where entry was previously not possible.