ETI VIEWS AND NEWS
ECONOMICS AND TECHNOLOGY, INC.
August 2010

*IN THIS ISSUE*



## New FCC interest in DoJ/FTC Horizontal Merger Guidelines for assessing dominant carrier market power

For much of the past decade and across a broad range of decisions affecting telecommunications carriers, the FCC has employed a variety of subjective and predictive approaches to the measurement of competitive activity and, more directly, the extent to which competition can be relied upon as an alternative to regulation in constraining incumbent carrier prices. In many instances, the Commission has employed indirect, *proxy* indicia of competitive activity rather than direct, quantitative evidence. One such approach has been the use of often arbitrary "triggers" and other essentially anecdotal evidence of the "presence" of some competition, without any direct examination or quantification of actual competitive activity or whether that "presence" is sufficient to constrain the incumbent's exercise of market power. In other cases, the FCC has relied upon its "predictive judgment" as to the impending arrival of competition even where little or none was actually in existence at the time its decision. And where such proxy or predictive evidence has been relied upon, the Commission had rarely if ever undertaken any *ex post* examination to determine whether the predicted competition had ever actually materialized.

There were several important developments earlier this year that bear upon this approach to competitive assessment. On April 15, the FCC released a Public Notice in WC Docket No. 09-135 – Qwest's Phoenix MSA forbearance petition – requesting comment "on whether, in considering Qwest's Phoenix MSA Petition, [the Commission] should apply a market power-oriented approach along the lines suggested in the FTC-DoJ *Horizontal Merger Guidelines* and the [AT&T/BellSouth, Verizon/MCI, and SBC/AT&T] Commission merger decisions." A few days later, on April 20, the DoJ and FTC released for public comment their long-awaited draft rewrite of the *Guidelines* (*HMG*). And on June 22, the FCC issued its decision denying Qwest's Phoenix petition for forbearance, finding generally that competition in the Phoenix MSA had not developed to the point where it could be relied upon to constrain the market power of the incumbent local exchange carrier (see *ETI Views and News* , July 2010). In reaching that decision, the FCC has relied upon a direct analysis of Qwest's market power rather than upon any indirect "triggers" or other proxy evidence. Concurrently with its Qwest decision, the Commission issued another Public Notice seeking comment on the use of a similar market power approach in other forbearance and similar policymaking dockets.

The confluence of these events suggests that the FCC may now be making fundamental changes to its approach to evaluating deregulatory initiatives, including possibly adopting a set of formal analytical standards for assessing incumbent carrier market power as a basis for either eliminating or retaining price regulation in specific telecom services and markets. The questions raised here by the FCC need also to be considered in the context of the proposed revisions to the HMG.

**Background**

The *1996 Telecommunications Act* imposed various regulatory requirements upon incumbent carriers, but also provided for the withdrawal of regulatory constraints and protections when certain conditions had been met. In some cases, the FCC and federal courts had interpreted these provisions in such a manner that the conditions can be satisfied by a fairly minimal level of competition. Here are some examples:

- Sec. 271(c)(1)(A) – one of the thresholds for RBOC long distance reentry in any in-region state – required the presence of "at least one" facilities-based competitor. The FCC interpreted this as requiring only a single competitor anywhere in that state, without much analysis as to the competitor's geographic coverage or whether its presence actually did constrain the Bell company's ability to leverage its dominance of the local market to also control the long distance market.
- Sec. 251(d)(2) requires ILECs to provide access to UNEs only where such access is "necessary" (sec. 251(d)(2)(A)) or where "the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer" (sec. 251(d)(2)(B)). After a federal court reversed several attempts by the FCC' to implement a test for impairment that recognized the significant barriers to CLEC entry, the FCC settled for a toothless impairment standard in which evidence that it has been feasible for *some* competitor to provide service *somewhere* without access to a particular network element has been a sufficient basis for finding "no impairment."
- Rather than perform a market power analysis, the FCC has determined that the presence of a certain number of collocations spread over a broad MSA-wide market would be sufficient to justify pricing flexibility (*Special Access Pricing Flexibility Order*).
- Having ruled that integrated broadband Internet access services

> that combined last-mile transmission with downstream Internet applications are "information services," the FCC has declined to apply its decades-old *Computer II/III* requirement that the basic telecommunications component of an information service – here, the last-mile link to the customer's residence – be offered to rival ISPs on an unbundled basis, on the same terms and conditions as the integrated ILEC provides for its own use. The removal of the unbundling requirement permits ILECs to undercut non-facilities-based ISPs and to leverage their market power in Internet access facilities into the adjacent (and separate) markets for Internet content and applications.

In none of these examples – and there are numerous others – were the ILECs required to show that they lacked market power and, more importantly, attempts by opponents of the deregulatory initiatives to demonstrate that the ILEC in question still maintained formidable market power were generally afforded little if any weight by the FCC. Had the presence of ILEC market power factored into the decision-making process – as it should have – the outcomes would have been quite different.

***The Horizontal Merger Guidelines as an Input to FCC Competitive Analysis***

The purpose of the *Horizontal Merger Guidelines* , as the title suggests, is to provide a framework for the Department of Justice and the Federal Trade Commission to assess the efficacy of proposed mergers and, specifically, whether merger approval would result in a lessening of competition in relevant product and geographic markets. This fundamentally antitrust focus of the *Guidelines* has led to their having received relatively little direct attention in regulatory circles – indeed, since "public utilities" were traditionally viewed as monopolies anyway, there seemed little purpose in applying tests for the diminution of competition when none was expected to begin with. Although the FCC has frequently referenced the *HMG* as a basis for market definition, it has not – at least in recent years – relied upon the comprehensive framework that the *HMG* provides for assessing competition and the potential anti-competitive effects of market power.

In its recent *Qwest Phoenix Forbearance Order*, the FCC recognizes that it has become too reliant upon predictions and indirect evidence and so has indicated its intent to apply an antitrust-type of market power analysis used in the *HMG* as an input to its competition analysis:

> ... we find it appropriate to adopt a more comprehensive analytical framework for considering forbearance requests like Qwest's. We thus return to a traditional market power framework ... to evaluate competition in telecommunications markets in forbearance proceedings such as this one. This approach also is comparable to the analysis used by the DOJ, FTC, and telecom regulators in other countries, including those in the European Community, to determine the extent of competition in a market. ... [W]e find that this framework is better suited to analyzing claims that competition in the legacy services market is sufficient to satisfy the three-part section 10 forbearance criteria, not only with respect to dominant carrier regulation, but also with respect to the other regulatory obligations at issue here, such as section 251(c)(3) unbundling. In particular, the Commission's market power analysis was designed to identify when competition is sufficient to constrain carriers from imposing unjust, unreasonable, or unjustly or unreasonably discriminatory rates, terms, and conditions, or from acting in an anticompetitive manner. This market power analysis is the precise inquiry specified in section 10(a)(1), and informs our assessment of whether carriers would have the power to harm consumers by charging supracompetitive rates. Finally, in making its public interest evaluations pursuant to section 10(a)(3) and section 10(b), the Commission is required to consider whether forbearance "will promote competitive market conditions."

Footnote references omitted. The current *HMG* applies several tests for market power and market concentration – the Herfindahl-Hirschman Index ("HHI") of market concentration, the potential for the merger to produce "a small but significant and non-transitory increase in price ('SSNIP')," and the relationship between price and marginal cost. As a general matter, these specific indicia have up to now been afforded only tertiary consideration – coming after "predictive judgments" and "triggers"– by the FCC and other telecom regulatory agencies in assessing the efficacy of reduced or forborne regulation. And in its *Qwest Phoenix Order*, the FCC appears now to concede these past errors:

> Recognizing the theoretical and empirical concerns associated with duopoly, the Commission, in the *Qwest Omaha Forbearance Order*, offered three predictive judgments, which it concluded would mitigate those concerns. It first predicted that Qwest would continue to make wholesale facilities, such as DS0, DS1, and DS3 facilities, available to competitors at "competitive rates and terms." Second, and relatedly, it predicted that non-cable competitors could "rely on the wholesale access rights and other rights they have under sections 251(c) and section 271 ... [to] minimize[] the risk of duopoly and of coordinated behavior or other anticompetitive conduct in this market." Third, it predicted that the areas where Cox currently had facilities would see further investment by Cox and by other competitors even without access to unbundled loops or transport. ... Upon further consideration, we find that these predictions have not been borne out by subsequent developments, were inconsistent with prior Commission findings, and are not otherwise supported by economic theory.

***The revised Horizontal Merger Guidelines***

Coincidentally, at the same time as the use of antitrust-type analysis of dominant carrier market power is gaining currency at the FCC, the DoJ and FTC have proposed substantial revisions to the *HMG* that would, if adopted, advance the FCC's ability to pursue this approach. The draft proposed rewrite of the *HMG* maintains and expands the existing tests for market power, and appears to place more emphasis than the current version upon such evidence. More importantly, while the draft *HMG*'s focus is obviously upon *mergers*, its specific analytical tests and indicia of market power can be readily adapted and applied to regulatory analysis:

- ... The business decisions taken by the merging firms also can

be informative about industry conditions. For example, if a firm sets price well above marginal cost, that normally indicates either that the firm is coordinating with its rivals or that the firm believes its customers are not highly sensitive to price.

- Explicit or implicit evidence that the merging parties intend to raise prices, reduce output or capacity, reduce product quality or variety, withdraw products or delay their introduction, or curtail research and development efforts after the merger, or explicit or implicit evidence that the ability to engage in such conduct motivated the merger, can be highly informative in evaluating the likely effects of a merger.

Draft *HMG*, §2.2.1. The draft *HMG* details specific types of evidence to be considered:

- Evidence of observed post-merger price increases or other changes adverse to customers is given substantial weight. (§2.1.1)
- ... historical events, or "natural experiments," that are informative regarding the competitive effects of the merger. For example, the Agencies may examine the impact of recent mergers, entry, expansion, or exit in the relevant market. Effects of analogous events in similar markets may also be informative.
- ... variations among similar markets. For example, if the merging firms compete in some locales but not others, comparisons of prices charged in regions where they do and do not compete may be informative regarding post-merger prices. (§2.1.2)
- ... market shares in a relevant market, the level of concentration ... (§2.1.3)

The draft *HMG* provides another test that is of particular relevance to telecommunications regulation – the "disruptive role of a merging party." Prior to the RBOC/IXC mergers, pre-merger AT&T and MCI played a crucial role as "disruptive" competitors, both in their business practices and as parties to state and federal regulatory proceedings. They aggressively supported the continued availability, at cost-based rates, of wholesale services including UNEs and special access. They supplied evidence to support significant productivity offsets in price cap plans, and for maintaining the regulatory oversight of ILEC retail services necessary to prevent price squeezes and other anticompetitive pricing practices. As competitors, these companies were chiefly responsible for the massive reductions in long distance rates following the *1996 Act;* they led the way toward the introduction of "all distance" plans and unlimited long distance calling; and they competitively disrupted ILEC overpricing of vertical features (e.g., call waiting, caller ID and voice mail) by making these features "free" in their new local service offerings. While the mergers eliminated AT&T and MCI, FCC and court actions are largely responsible for the elimination of other disruptive providers whose regulatory and market participation had been responsible for advancing the availability of Internet access services. Data CLECs such as Covad, Rhythms and NorthPoint provided the telecommunications services that permitted competitive dial-up Internet access to develop at a time when ILECs had no interest in this service. These companies also pushed hard for UNE availability of the "high frequency" portion of residential POTS access lines, and in so doing brought ADSL to residential customers several years before the RBOCs commenced their own active involvement in this market. The FCC largely overlooked the benefits of these disruptive competitors when it adopted policies such as (1) the 2001 *ISP Remand Order*, that disrupted the intercarrier compensation rules with respect to ISP-bound traffic, (2) the elimination of line sharing, and (3) the *Broadband Wireline Internet Access* order. These and other FCC decisions have financially crippled the competitive carriers who had been instrumental in bringing dial-up Internet access to all but the most rural parts of the country. In this regard, the draft *HMG* would specifically consider

> ... whether a merger may lessen competition by eliminating a "maverick" firm, i.e., a firm that has played, or likely will play absent the merger, a disruptive role in the market to the benefit of customers. For example, if one of the merging firms has a strong incumbency position and the other merging firm threatens to disrupt market conditions with a new technology or business model, their merger can involve the loss of actual or potential competition. Likewise, one of the merging firms may have the incentive to take the lead in price cutting or other competitive conduct or to resist increases in industry prices. A firm that may discipline prices based on its ability and incentive to expand production rapidly using available capacity also can be a maverick, as can a firm that has often resisted otherwise prevailing industry norms to cooperate on price setting or other terms of competition. (§2.1.5)

There is considerable evidence that in the post-merger, post-deregulation world now dominated by AT&T and Verizon, there have been a major escalation in prices and little growth in competition. The proposed revision to the *HMG* presents the FCC with a solid analytical roadmap for a comprehensive review of its past "predictive judgments" and for revisiting those regulatory actions that, in retrospect, were lacking in any solid factual foundation.

*For more information on this subject, please contact Dr. Lee Selwyn at lselwyn@econtech.com.*

## Should different regulatory treatment apply to wireline vs. wireless broadband Internet access?

While most facilities-based broadband service providers – telcos, cablecos, and wireless carriers – remain staunchly opposed to the imposition of any meaningful net neutrality rules, the wireless industry has been particularly outspoken in its efforts to assure a wireless carve-out with respect to any rules that the FCC might ultimately adopt. Wireless carriers have gone to great lengths to differentiate wireless Internet access from wireline, by engineering various hardware- and software-based linkages between basic Internet access and proprietary content and applications that they provide. These linkages, they argue, are so basic and essential to the operation and management of wireless networks as to make it impractical, if not altogether impossible,

for net neutrality rules to be implemented for wireless Internet use. But do these essentially self-created technical distinctions between wireless and wireline Internet access justify the net neutrality carve-out that wireless carriers demand?

To be sure, wireline services are subject to fewer capacity constraints than wireless, which is necessarily limited to available electromagnetic spectrum. Beyond that, however, the underlying telecommunications transmission supporting both of these forms of Internet access are quite similar.

***Artificial distinctions***

Unlike the wireline broadband environment where users typically select the device and software (e.g., a computer, operating system, web browser, and any number of third party applications) they will use for Internet access, wireless carriers in the US require their customers to use only carrier-approved handsets controlled by carrier-limited software. Even though there is no legal, regulatory or technical basis for these restrictions, the vast majority of wireless handsets sold in the US are carrier-branded, i.e., provided either directly through a carrier-owned retail outlet or through a carrier-authorized agent or reseller. In this way, the carrier acts as "gatekeeper" with respect to handset functionality.

Users of traditional wireless handsets (i.e., not "smartphones"), are often limited to accessing the web through a carrier-specified browser that imposes severe limits on the form of the web content that can be viewed. The consumer is offered the opportunity to purchase a limited array of proprietary add-on features, *but only via a carrier-operated portal*. These include such things as ringtones, games, and music downloads. In general, the customer is blocked from purchasing these from any non-carrier-approved source. *There is no technical basis for any of these limitations:* the underlying wireless data network, like the wireline Internet, is totally agnostic as to what type of content is being carried, or what application receives the data at either end. Claims to the contrary are reminiscent of the old "harm to the network" warnings frequently advanced by telcos back in the 1950s and '60s in their (ultimately – and fortunately – unsuccessful) efforts to persuade the FCC not to allow customers to interconnect their own handsets, business phone systems, and other "customer premises equipment" with the public telephone network.

"Smartphones" can communicate with most ordinary HTML websites via a traditional (non-carrier) web browser, can download photos, videos, and other content directly from the web rather than being limited to a carrier-sponsored portal and, subject to the technical properties of the smartphone device, can purchase and use applications authored by sources other than those "approved" by the carrier. Wireless carriers have nevertheless persisted in placing artificial restrictions as to the permitted uses their smartphone customers can make of the underlying data stream. For example, Apple and AT&T have an exclusive arrangement whereby Apple's *iPhone* is available in the US only for use on the AT&T network, and Apple limits the applications offered to *iPhone* users by requiring that all "apps" be purchased solely through its proprietary "App Store." Some of the restrictions on the App Store are clearly set by Apple, but others (such as limitations on third party VoIP access to the 3G data stream) are likely carrier imposed. These restrictions are also artificial – hackers have utilized a process known as "jailbreaking" to remove the Apple/AT&T restrictions on available applications, affording the user access to non-approved apps and unfettered access to the basic TCP/IP stream, and *iPhones* have been successfully unlocked and used on networks other than AT&T.

Wireline Internet users are currently afforded many other freedoms not available with wireless access. For one, since *any* Internet-capable device can be used with wireline Internet access, users can easily overcome any hardware or software restriction by simply utilizing a different device – a fact that effectively prevents most hardware manufacturers and software developers from seeking to impose artificial and arbitrary limitations on the capabilities of their products. In contrast, tie-ins between wireless carriers and authorized wireless devices operate to reduce competition in the wireless device and software market to the same relatively noncompetitive condition extent in the wireless services market. Imposition of rules mandating device independence and net neutrality on wireless services would materially alter this condition.

***Implications of carrier-created differences***

These fabricated restrictions are emblematic of the fundamentally noncompetitive character of the US wireless market. As we had discussed in July's *Views and News*, there has been a increasing trend toward greater concentration among US wireless carriers. Consolidations and growing consumer dependence upon wireless services have expanded the market power of the four national carriers – AT&T Mobility, Verizon Wireless, Sprint, and T-Mobile – market power that does not seem to have been diminished following the entry of disruptive competitors such as MetroPCS, which offers its services *sans* contracts, early termination fees, and surcharges. That notwithstanding, the "big four" carriers have nevertheless been able to impose contracts with onerous terms and conditions, as well as a variety of use restrictions applicable to data services, while remaining successful in forcing the vast majority of subscribers to accept them. Importantly, the prevailing restrictions present in wireless Internet services should be regarded as providing a strong indication as to what portends for wireline services if ILECs and cablecos are permitted to engage in these same practices. Whatever artificial linkages may be crafted between wireless Internet access and certain "information services" do not alter the fundamental *telecommunications* character of the wireless Internet access service and, like wireline Internet access, these too should be subject to similar net neutrality regulations.

For more information on this subject, please contact Colin B. Weir at *cweir@econtech.com*.



**About ETI.** Founded in 1972, Economics and Technology, Inc. is a leading research and consulting firm specializing in telecommunications regulation and policy, litigation support, taxation, service procurement, and negotiation. ETI serves a wide range of telecom industry stakeholders in the US and abroad, including telecommunications carriers, attorneys and their clients, consumer advocates, state and local governments, regulatory agencies, and large corporate, institutional and government purchasers of telecom services.