APPENDIX A

RESPONSE TO PROF. HAUSMAN'S CRITICISMS OF PROF. SCHWARTZ'S ANALYSIS FOR THE DEPARTMENT

In its previous evaluations, as well as this one, the Department has relied on the Affidavit[1] and Supplemental Affidavit[2] of Prof. Marius Schwartz in support of its standard for evaluation and consideration of the public interest entry criterion of section 271 of the 1996 Act. The Supplemental Affidavit, and the Department's South Carolina Evaluation at 48-50 (attached to this Evaluation as Exhibit 5), address issues that other economic experts have raised regarding Prof. Schwartz's original analysis in his Affidavit, and explain why that analysis remains valid. Only one of BellSouth's economic experts, Prof. Hausman, has attempted to respond to Prof. Schwartz's Supplemental Affidavit in any detail.[3] Most of his arguments have already been addressed by Prof. Schwartz and other experts, while others are simply unclear. For example, Prof. Hausman seems to think that Prof. Schwartz should change his position on the cost-benefit tradeoff of requiring local market opening before BOC interLATA entry in the wake of the Eighth Circuit's recent decision on the Commission's local competition rules. But nothing in the Eighth Circuit's decision affects the validity of Prof. Schwartz's

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[1] Affidavit of Marius Schwartz, ("Schwartz Aff."), attached to this Evaluation as Ex. 1.

[2] Supplemental Affidavit of Marius Schwartz, ("Schwartz Supp. Aff."), attached to this Evaluation as Ex. 2.

[3] Reply Declaration of Prof. Jerry A. Hausman ("Hausman South Carolina Reply Decl."), attached to Reply Brief in Support of Application by BellSouth for Provision of In-Region, InterLATA Services in South Carolina, <u>In re: Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in South Carolina</u>, CC Docket No. 97-208 (Nov. 14, 1997) ("BellSouth South Carolina Reply Brief") as App. Tab 2.

observation that prematurely granting BOC interLATA entry before the process of opening local markets is completed would likely encourage further delays that would "substantially impede the development of local competition." Schwartz Supp. Aff. ¶ 58. Not only would this create a clear harm to local consumers in the short term, but over the longer term, as Prof. Schwartz points out, "if local competition fails to develop exchange access alternatives, then BOC interLATA entry is likely, over time, to pose a growing threat to the ability of IXCs to compete, since IXCs' access needs will change over time and preventing discrimination in the establishment of new access arrangements is considerably harder than preventing the degradation of established arrangements." Schwartz Supp. Aff. ¶ 70 (citation omitted); see also id. ¶ 11.[4]

The more specific criticisms that Prof. Hausman directs at Prof. Schwartz's analysis are generally mistaken, and in a number of instances self-contradicting. For example:

- Prof. Hausman insists on the need to include consideration of elasticity of demand and changes in price, as well as market size, in the comparative market analysis,[5] yet nowhere in his own analysis does he consider such factors for any of the types of products and services included in the local markets served by the BOCs, apart from basic flat-rate residential local exchange service, the one type of local service that arguably is

[4] Prof. Hausman continues to characterize inaccurately what Prof. Schwartz has said about competitive effects in long distance markets. Compare Schwartz Supp. Aff. ¶ 70 n.22, with Hausman South Carolina Reply Decl. ¶ 6 & n.3, and Declaration of Jerry A. Hausman ¶ 41 ("Hausman Louisiana Decl."), attached to Brief in Support of Application by BellSouth for Provision of In-Region InterLATA Services in Louisiana, CC Docket No. 67-231 (Nov. 6, 1997) ("BellSouth Louisiana Brief") as App. A, Vol. 1, Tab 5, which Prof. Hausman has not changed from his submission in South Carolina.

[5] Hausman South Carolina Reply Decl. ¶ 31.

priced at or below cost.[6] Prof. Schwartz, in contrast, identified a number of BOC services, such as intraLATA toll, vertical services, ISDN and exchange access, that are over-priced and where competition is particularly likely to yield price benefits and increased output. And, as Prof. Schwartz has pointed out, competition will yield benefits in the provision even of currently subsidized services, as universal service subsidies are reformed on a competitively neutral basis and become available to all providers, not just incumbent LECs. Schwartz Supp. Aff. ¶ 23.[7]

- Both Prof. Schwartz and Prof. Hausman use the same long distance industry elasticity of demand of .7 in their evaluations of long distance markets.[8] Prof. Hausman inappropriately criticizes Prof. Schwartz for doing so,[9] arguing he should have used firm elasticity instead. But Prof. Schwartz has correctly used the industry elasticity figure for the specific purposes indicated in his affidavit, which were (a) to compute the effect on the amount of access revenues associated with the <u>industry</u>-wide price change assumed

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[6] Hausman Louisiana Decl. ¶¶ 24-25.

[7] The Consumer Federation of America, in its reply comments on BellSouth's interLATA entry application in South Carolina, has actually compared in quantitative terms the potential benefits of greater competition in local and long distance markets, building on the analysis by Prof. Schwartz. The CFA has estimated that while excess profits that might be returned to consumers from greater competition in long distance markets amount to $0-2 billion annually, excess profits that could be returned to consumers from greater competition in all local markets amount to $8-12 billion annually. Reply Comments of the Consumer Federation of America, <u>In re: Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of InRegion, InterLATA Service in South Carolina</u>, CC Docket No. 97-208 at Table 1 and App. A (Nov. 14, 1997).

[8] Hausman Louisiana Decl. ¶¶ 14, 20.

[9] Hausman South Carolina Reply Decl. ¶ 36.

by Prof. Hausman, and (b) to refute Prof. Hausman's suggestion that firms such as BOCs in the long-distance <u>industry</u> would have no incentive to raise the <u>industry</u>-wide price levels if they could. Schwartz Supp. Aff. ¶¶ 65, 68-70, 72-74.

- Prof. Hausman dismisses the potential price benefits from basic local exchange competition as "essentially zero" based on change in overall quantity of demand for a static product,[10] without considering the potential benefits consumers could realize from competition among firms, as well as other benefits from competition in the form of new products and improved service. He also simply assumes that because prices in local markets are regulated, there is nothing to be gained by introducing competition in them,[11] failing to address the well-recognized limitations of regulatory constraints compared with competitive ones that Prof. Schwartz identified, as well as the potential benefits of innovation. Schwartz Supp. Aff. ¶¶ 18-25. Prof. Hausman's views are at odds with the underlying premise of the Telecommunications Act that regulated monopoly is far inferior to competition in ensuring that local telecommunications services are most efficiently provided to consumers. In fact, as indicated by Prof. Hausman's own analysis of long distance markets, a large share of the benefits to consumers from increased competition in telephone services reflects transfers to consumers derived from reductions in price, rather than simply increases in aggregate usage (though such increases would occur as well), and this can be expected to hold true for local services as well, so that

[10] Hausman Louisiana Decl. ¶ 25.

[11] Hausman South Carolina Reply Decl. ¶¶ 31-32; Hausman Louisiana Decl. ¶ 25.

Prof. Hausman's exclusive focus on industry elasticity of demand is inappropriate in evaluating costs and benefits in this context.

- Prof. Hausman continues to defend the "double marginalization" theory at the core of his analysis, while accusing Prof. Schwartz of misperceiving BOC incentives.[12] However, Prof. Schwartz was addressing BOC ability to reduce prices in the manner alleged, not incentives. As Prof. Schwartz points out, section 272(e)(3) of the 1996 Act requires that BOCs and their subsidiaries impute access charges, and "[t]his requirement would seem to restrict the BOCs' ability to behave in the manner stipulated by Professor Hausman and others." Schwartz Supp. Aff. ¶ 65. Prof. Hausman merely assumes that the statutory imputation requirements will be ineffective in affecting BOC behavior, yet he also assumes that BOC entry would be in compliance with the minimum requirements of the 1996 Act such as those in section 272.[13] At the same time, Prof. Hausman completely fails to respond to Prof. Schwartz's point that if the double marginalization concern were valid, it would apply with equal or greater force to benefits that could be realized from allowing long distance carriers to integrate vertically into local markets. Schwartz Supp. Aff. ¶¶ 66-67.

- In responding to Prof. Schwartz's key observation that an increase in BOCs' market share in long distance services could be achieved largely by diverting existing output and revenue away from IXCs rather than expanding industry output, Schwartz

[12] Hausman South Carolina Reply Decl. ¶ 34.

[13] Hausman South Carolina Reply Decl. ¶ 34; Hausman Louisiana Decl. ¶¶ 25, 42.

Supp. Aff. ¶ 74, Prof. Hausman mistakenly accuses Prof. Schwartz of trying to protect IXC's profits rather than consumer welfare.[14] He overlooks the very next sentence of Prof. Schwartz's analysis, in which Prof. Schwartz explained the relevance of his observation about diversion -- that, contrary to Prof. Hausman's claims, a BOC's substantial increase in long distance revenues "need not hinge on reducing industry price significantly; and hence a BOC may not have strong incentives to cut interLATA prices." Schwartz Supp. Aff. ¶ 74. This conclusion obviously goes directly to the issue of consumer welfare effects from BOC long distance entry.

- Though Prof. Hausman claims, in his long distance price analysis, to have averaged price differences over different customers' usage patterns,[15] it appears that he did so only by numbers of customers in each class, not by calling volume or revenues, which would greatly skew the results in light of the well-recognized large disparity between revenues and customer numbers.
- Prof. Hausman simply declares that BOCs will not have competitive advantages over IXCs in bundled services because competitors would also have the ability to bundle.[16] But the parity that Prof. Hausman casually assumes, in this and other respects, will not in fact exist until local markets have been fully and irreversibly opened to competition, e.g., through the establishment of nondiscriminatory wholesale support

[14] Hausman South Carolina Reply Decl. ¶ 37.

[15] Hausman South Carolina Reply Decl. ¶¶ 38 n.26, 39.

[16] Hausman South Carolina Reply Decl. ¶ 11.

systems scaleable to meet competitive demand for resale and unbundled network elements, and procompetitive pricing of the local services and facilities that competitors must purchase from the BOC.

Prof. Hausman's attempted reliance on comparisons with telecommunications markets in the United Kingdom and Canada to support his claims is similarly unjustified:

- Competition in the United Kingdom. In complaining that Prof. Schwartz and others have not addressed evidence from the United Kingdom telecommunications markets about the development of local competition,[17] Prof. Hausman himself fails to present an accurate picture of developments in U.K. telecommunications markets and the special circumstances underlying them. Prof. Hausman's argument that full compliance with the requirements of section 271 is not needed because local competitors have attained a collective 7% local market share in the U.K. without unbundling of network elements fails to appreciate several significant differences between the U.K. and the U.S. In the U.K., local competition was authorized nationwide over six years ago. The Telecommunications Act has been in effect in the U.S. only since February 1996, less than two years as of this filing, and there is no basis yet for evaluating the efficacy of the U.S. and U.K. approaches to local competition over a comparable time period of sufficient duration. The primary local competitors in the U.K. have been facilities-based cable companies that built out two-wire networks from the start for both cable and telephony services (unlike the one-wire U.S. cable systems constructed earlier), so that

[17] Hausman South Carolina Reply Decl. ¶ 35 n.22.

they did not have to incur additional expenses to rewire their networks for telephony (unlike U.S. cable companies).[18] Moreover, after six years of local competition, BT still retains substantial market power in local as well as domestic long distance services in the UK, as the Department has recently found.[19] The relevant point is not whether the U.K. has been able to achieve some degree of local competition relying exclusively on buildout of separate facilities -- an option primarily undertaken through the simultaneous initial installation of two wires by cable systems in the U.K, which is not possible for the already existing U.S. cable systems -- but rather whether the U.S. model, with its three entry paths, ultimately succeeds in bringing about a still more competitive local market. There is no basic disagreement in policy between the U.S. and the U.K. on the benefits of opening both local and long distance telephony markets, notwithstanding differences in the roads taken to reach that goal. In this regard, Prof. Hausman overlooks findings of the British regulator OFTEL concerning price trends in the U.K. before and after local competition began to develop,[20] which tends to bear out Prof. Schwartz's observation that

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[18] Moreover, in the U.K. development of competition has been overseen by a single regulatory authority with comprehensive nationwide jurisdiction, in contrast with the U.S., where the resolution of fundamental issues of implementation, which is still underway, has taken place in the context of a far more complex federal system.

[19] United States v. MCI Communications Corp and BT Forty Eight Company, Civil Action No. 94-1317 (TFH), Memorandum of the United States in Support of Modification of the Final Judgment, at 5-6 (D.D.C. filed July 7, 1997).

[20] Substantial prices decreases have occurred for many services in local markets in the U.K. between 1991 and 1996, after local competition began to emerge, and the weighted average of BT's local and long distance prices overall has been going down over the period since local competition began, whereas before such local competition existed in 1984-1991 and BT faced competition only in long distance markets, BT's weighted average of price changes as an

competition in both local and long distance markets will better serve consumers than allowing vertical integration by a single carrier that retains a local monopoly. Schwartz Supp. Aff. ¶ 12. The U.K. authorities also reached the same conclusion in 1991, after several years of experience with a long distance duopoly and no local competition.[21]

- <u>Competition in Canada.</u> Prof. Hausman also cites as evidence of the benefits to be realized from vertical integration of BOCs into long distance certain prices available from vertically integrated long distance carriers in Canada,[22] but in fact the prices he relies on are no lower than the best prices already widely available in the United States from various non-integrated long distance providers that Prof. Schwartz has identified,[23]

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integrated provider of services in local and long distance markets was increasing. OFTEL, Pricing of Telecommunications Services from 1997, Annexes to the Consultative Documents, Issued by the Director General of Telecommunications, Annex B, Trends in prices and quality of service, at 6, Table B2(a), attached to this Evaluation as Exhibit 8 (showing net cumulative increase in weighted average of BT local and long distance prices of +14.2% between 1984, when long distance competition began, and 1991, when the U.K. changed its duopoly policy and began authorizing local competition by cable providers, and net cumulative decrease in weighted average of BT local and long distance prices of -15.4% between 1991 and 1996).

[21] Department of Trade and Industry, Competition and Choice: Telecommunications Policy for the 1990s, at iii-iv (Mar. 1991) (concluding that the opening of all telecommunications markets in the U.K. to competition would lead to more choice of services, a wider range of services, and a more rapid decline in prices than would have otherwise occurred).

[22] Hausman Louisiana Decl. ¶ 27; Hausman South Carolina Reply Decl. ¶ 35.

[23] Compare the long distance prices, in US dollar equivalents, that Prof. Hausman cites of 12.2 cents per minute for BC Tel in British Columbia, and 10-11.5 cents per minute for Telus in Alberta, Hausman Louisiana Decl. ¶ 27, to the rates that can already be obtained in the U.S. under various pricing plans of 12 cents per minute from MCI, 10 cents from AT&T and Sprint, and 9 cents per minute from LCI. Schwartz Supp. Aff. ¶ 85 n.38. Prof. Hausman's limited comparisons of a few Canadian carriers' rates with those of U.S. carriers under some pricing plans and periods cannot yield any supportable conclusions as to the relative overall competitiveness of U.S. and Canadian long distance markets.

and are also similar to the average revenue received on a domestic U.S. long distance minute.[24]

[24] In 1996, average billed revenue per interstate direct dialed domestic minute in the U.S. was 11.57 cents, inclusive of access charges. Federal Communications Commission, Telecommunications Industry Revenue: TRS Fund Worksheet Data at Figure 5 (Nov. 1997).