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IN TELECOMMUNICATIONS**

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COMPETITION POLICY IN TELECOMMUNICATIONS:

THE CASE OF THE UNITED STATES OF AMERICA

November 2002

This case study has been prepared by John Alden <ja@htgm.com>, Vice President, Freedom Technologies. *Competition Policy in Telecommunications: The Case of the United States of America* is part of a series of Telecommunication Case Studies produced under the New Initiatives program of the Office of the Secretary General of the ITU. The competition policy case studies programme is managed by Eric Lie <eric.lie@itu.int> under the direction of Tim Kelly <tim.kelly@itu.int>. Other country case studies on competition policy, including Denmark and India can be found at <http://www.itu.int/osg/spu/ni/competition>. The opinions expressed in this study are those of the author and do not necessarily reflect the views of the International Telecommunication Union, its membership or the Government of the United States of America.

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1 Introduction

As the 21st Century gets under way, the global telecommunications sector is struggling with uncertainties. In many countries, governments are only now emerging from a paradigm shift in which telecommunications has, for the first time, come to be seen as a market-driven industry rather than a national utility. Everywhere, it seems, governments are struggling to strike a balance between allowing markets to function without interference, where possible, and interfering to correct market dysfunctions, where necessary.

In the United States, the difficulties of market regulation are complicated by the lingering effects of an economic recession that has struck particularly hard at communications industries. Moreover, government and industry alike are coping with the fallout of corporate governance scandals affecting many of the major players in these industries. The year 2002 will likely be remembered as one of flux and difficulty for the industry—particularly in the United States.

Yet for many reasons, the United States remains an important subject for a case study on competition policy. The country has a century-long tradition of antitrust law enforcement, and nearly as long a tradition of sector-specific regulation. Within that context, the United States has been pursuing competition as a stated policy goal for longer than many other countries. U.S. policy-makers have well-articulated policies on market entry and asymmetrical regulation, for example, that date back to the early 1980s.

Another reason to focus on the United States is the evidence that technological convergence and “intermodal” competition are happening within the market, putting pressure on competition policy to adapt quickly. The U.S. policy-making system is not prone to complete re-designs to facilitate change. The broad dispersion of power and incremental nature of its political system militate against that. Nor is there any consensus that wholesale change is needed. But policy-makers are working within the existing policy structure to address perceived market shortcomings in local exchange service and, particularly, in broadband network deployment. In short, sector-specific competition policy is undergoing a rigorous re-examination and reappraisal in the United States.

Following a brief country background section, Section 2 of this report examines the history of telecommunications competition in the United States, as well as the current status of competition. Section 4 explores the legal foundations of competition policy, as well as the governmental structure of the agencies and departments that develop, implement and enforce it. Section 5 studies the implementation of competition policy precepts in sector-specific regulation and general antitrust law enforcement. Section 6 concludes with an assessment, recommendations and listing of areas for further study.

2 Country Background

The United States of America is a diverse nation that has grown from its roots in European colonization into one of the most important economic and political players in the world. An increasingly polyglot nation, the United States has been built through waves of immigration from nearly every nation of the world. Meanwhile, it has sought to maintain the common law traditions and constitutional system it established at its founding as a democratic republic more than 200 years ago.

2.1 Overview

The United States encompasses some 3.54 million square miles, stretching from above the Arctic Circle to Polynesia.¹ The U.S. decennial census in 2000 recorded a population of 281.42 million, a figure that has grown to 287.91 million in 2002 estimates.² The population grew by an estimated 1.2% from April 1, 2000 to July 1, 2001, and 13.1% between 1990 and 2000.³

Figure 2.1: Map of the United States of America



Source: *The World Fact Book 2002*

The U.S. population is ethnically and racially mixed. Americans reporting themselves as “white” (of European descent) in the 2000 census constituted 75% of the population.⁴ African-Americans constituted 12.3%, while those of Asian descent were 3.6%. American Indian, Alaskan and Pacific Islander populations total 1%. The most notable demographic trend is the rapid growth of the Hispanic population. Roughly 12.5% of Americans identified themselves as Hispanic or Latino in 2000, making them the largest American ethnic minority group.

Median annual household income in the United States was \$42,148 in 2000. Household income for Hispanics and African-Americans, however, continued to lag behind the national median but had reached historic highs, at \$33,447 and \$30,439, respectively.⁵ The relative wealth of the United States masked the fact that in 2000, 11.3% of the population lived in poverty—largely unchanged from the figure of 11.1% in 1973.⁶ Moreover, nearly 20% of the nation’s children were growing up poor.⁷ Altogether, the United States ranks sixth on the United Nation’s Human Development Index, just slightly ahead of the Netherlands and Japan and behind Norway, Australia, Canada, Sweden and Belgium.⁸

2.2 Government

Under a constitution ratified in 1789, the United States is a federal republic consisting of a union of 50 states, with powers divided between the federal and state governments. The federal government consists of three co-equal branches:

- An executive headed by a president;
- A legislative branch headed by a bicameral Congress; and
- A federal court system culminating in a Supreme Court.

A key element of the federal system is the division of powers, not only among the three branches of the federal system but between federal and state levels. The federal Supreme Court has the power of judicial review over all state and federal legislation and decides constitutional and jurisdictional issues.

Members of the Supreme Court are nominated by the president and confirmed by the Senate, the upper house of Congress. The president is indirectly elected, every four years, by an Electoral College. Members of Congress' House of Representatives are directly elected every two years, while Senators run for election every six years. The president's cabinet oversees a large executive branch bureaucracy (the functional equivalent of government ministries), and Congress has created a number of independent agencies that report to Congress.

State governments largely mirror the federal system. Directly elected governors oversee state-level departments and agencies, which implement legislation enacted by state legislatures. State courts interpret state constitutions and administer criminal and civil legal systems. Local government is provided by cities, counties, and townships, which are generally chartered by, or responsive to, state governments.

There are two major political parties in the United States, the Democratic Party and the Republican Party.⁹ At present, the U.S. electorate is deeply divided between the two parties, with the balance of power nearly split between them. The 2000 presidential election was disputed, with Republican George Bush taking office only after intervention by the Supreme Court. Democrats in 2002 hold a single-seat margin in the Senate, while Republicans claim a narrow margin in the House of Representatives. Congressional elections were slated for early November 2002, with control over Congress at stake.

2.3 Economy

Following a long period of economic expansion that lasted for most of the 1990s, the U.S. economy stalled in 2001, with its gross domestic product ("GDP") growing only 0.3% for the year. For three quarters of the year, the economy actually shrank, putting the United States into its first recession since 1991-92. According to revised statistics released by the Department of Commerce, GDP declined in the first quarter of 2001 by 0.6%, and by 1.6% and 0.3% during the second and third quarters, respectively.¹⁰ The recession came after a decade in which the economy grew briskly, with GDP growing by 4.1% in 1999 and 3.8% in 2000.

The economy recovered from its swoon in the last quarter of 2001 and enjoyed a vigorous first quarter of 2002, with GDP growth of 5%.¹¹ The economy stumbled again at mid-year 2002, however, posting anaemic GDP growth of 1.1% and prompting fears of a "double dip" recession. The nation's Federal Reserve System (which functions as a central bank) kept short-term interest rates at low levels in an effort to spur consumer spending and increased business investment during the latter half of 2002.

The strategy appeared to be working moderately well. Consumer spending grew a reported 3.1% in the first quarter of 2002 and 1.9% in the second.¹² There was no threat, however, of inflation. The U.S. consumer price index for urban consumers, for example, reflected just a 1.5% annual inflation rate in July 2002, down from a larger (but still moderate) rate of 3.7% in January of 2001.¹³ Business activity remained flat, though, amid reports that in the second quarter, businesses had cut by 17.7% their capital investments in plant, office buildings and other infrastructure. Meanwhile, in May 2002, the U.S. foreign trade deficit jumped to an unprecedented \$37.6 billion, with imports of goods and services totaling \$118.3 billion and exports totaling \$80.6 billion.¹⁴

The aftermath of the recession and the uncertain recovery of the U.S. economy took its toll on the U.S. population in 2002. Unemployment reached 8.3 million in July—a rate of 5.9%, which was up from just 4% in 2000.¹⁵ Meanwhile, trillions of dollars of U.S. stock assets had evaporated in the bear market, in some cases wiping out retirement savings and forcing people back into an uncertain job market.

3 Telecommunications Competition in the United States

3.1 From Natural Monopoly to Competition

3.1.1 Early Developments

Unlike most other countries, the United States never nationalized its telecommunications industry. From 1876 to 1893, American Telephone and Telegraph Co. (AT&T) emerged as the leading commercial force in developing telephone services and networks, on the strength of patents it held for the technology developed by Alexander Graham Bell.¹⁶ After 1893, when several key patents expired, the United States saw a profusion of small and large telephone companies, resulting in a jungle of overhead lines in many of America's cities. Many larger cities were served by multiple, competing phone companies.¹⁷ There was no sector-specific regulation at this time and much regulation of telephone company activities was carried out by local authorities.

In 1899, AT&T reorganized and became the parent company of the vertically integrated Bell System, which provided both local exchange service and long distance service. That same year, some of the more than 3,000 small independent carriers attempted to set up a rival long-lines network but failed for lack of capital.¹⁸ The Bell System at this time began a process of buying up independents, pressuring them into consolidation at times by refusing to sell equipment to them or to interconnect with them.¹⁹ Congress passed the Mann-Elkins Act in 1910, giving the Interstate Commerce Commission regulatory control over telegraph and telephone services and designating telephone companies as "common carriers."

In 1913, threatened with potential action under the nation's relatively new antitrust laws (See Section 4), AT&T agreed in the Kingsbury Commitment to interconnect with independents and to obtain approval from the federal Department of Justice before acquiring further competitors.²⁰ A loophole in the agreement, however, allowed further consolidation if "special reasons existed making the transaction desirable for the protection of the general public service or Bell System property."²¹ This allowed AT&T considerable leeway to continue its consolidation of dominance over the U.S. telecommunications industry.

AT&T's dominance was aided by regulatory policies, which at this time pointed to a "natural monopoly" as the most cost-effective structure for network-based utilities.²² State regulators often led the way in policies promoting consolidation and opposing "duplication" of network facilities.²³ As a result of state and federal policies reflecting this desire for economic "efficiency," by 1934 the Bell System was solidly entrenched, with its phone companies generating 94.3 percent of all local exchange calls.²⁴ The creation of the Federal Communications Commission (FCC) in the Communications Act of 1934 preserved the "regulated monopoly" paradigm.

Cracks in the armour of AT&T's dominance of the sector did not come until the 1950s and 1960s, with the advent of customer premises equipment (CPE) that could be attached to, or used with, the existing AT&T network. In a series of decisions, the FCC rejected AT&T's argument that allowing non-proprietary CPE would damage the AT&T network. FCC actions liberalizing access to the network opened the door conceptually for challenges to AT&T's monopoly on long distance service, as well.

3.1.2 The Bell System Divestiture

In 1969, the FCC authorized the company known later by its initials, MCI, to provide a private line microwave link between Chicago and St. Louis.²⁵ MCI subsequently began to offer its "Execunet" service, which constituted direct competition with AT&T's monopoly long distance offerings. In 1974, the Department of Justice brought an antitrust lawsuit against AT&T, alleging that it had violated federal law by using its control over local telephone networks to foreclose competition in long distance and CPE markets.²⁶ After many pre-trial motions, the case went to trial in 1978, and then was settled in 1982.

The result of this settlement was the Modification of Final Judgment, commonly known as the “MFJ,” which was attended by the AT&T Antitrust Consent Decree.²⁷ This agreement between AT&T and the Justice Department, filed with a federal District Court in Washington, DC, restructured the U.S. telecommunications sector. To end AT&T’s practice of using control over local networks as a means to preclude competition for long distance services, the company was required to divest its local telephone companies, known as the “regional Bell operating companies” or “RBOCs.” These “Baby Bells” were consolidated under seven regional holding companies or “RHCs” in different parts of the country.²⁸ The RBOCs (more recently “BOCs”) could not originate toll calls that would cross the boundaries of arbitrarily drawn districts known as “LATAs.”²⁹

The Bell System divestiture boosted competition among carriers providing interstate long distance services throughout the late 1980s and the 1990s. By 1995, however, the market for wireline *local* services remained largely in the hands of incumbent telephone companies—either the BOCs or independents. Divestiture had split the BOCs from AT&T, but it had not directly addressed the issue of local service competition. The FCC, meanwhile, was limited in its ability to act on local services, because the Communications Act of 1934 did not give it authority to regulate *intrastate* telecommunications that originated and terminated within a single state. That included local switched services, which were regulated by the state regulatory commissions.

3.1.3 The Telecommunications Act of 1996

The states, on their volition, had already begun to consider and take actions to dismantle legal and regulatory barriers to local service competition where they existed in state law. But many in the industry feared that a state-by-state approach to promoting full local service competition would result in a hodgepodge of different approaches and regulatory frameworks. So the industry pressed Congress to adopt national legislation.

The resulting Telecommunications Act of 1996 or “Telecom Act” (which amended the 1934 Communications Act) established a national policy to promote competition at all levels of telephony. The Telecom Act retained the Decree’s provisions preventing the BOCs from providing interLATA long distance services, at least initially. It allowed the BOCs to win relief from that prohibition, however, if they could prove they had undertaken all necessary steps to allow competitors to enter local service markets, where they had held monopolies for most of the century. In addition, the Telecom Act directed local exchange carriers (“LECs”) to interconnect and, in some cases, to allow unbundled access for competitors to lease network facilities for their own offerings.

In essence, then, the rough century between 1893 and 1996 could be characterized as a cycle in which the U.S. market moved from a proliferation of rival carriers, through sanctioned consolidation under the Bell System, and then back again toward a model of active industry competition. The FCC and antitrust authorities were both agents of change, although they did not both begin working, in tandem, to promote competition until the era of Divestiture.

3.2 The Current State of U.S. Telecom Competition

By many measures, the U.S. has one of the most competitive telecommunications markets in the world. But although it has spent some 30 years working to establish a policy and regulatory framework to promote competition, that does not mean those efforts have been universally successful or that U.S. markets function wholly rationally.

As a threshold matter, the Telecom Act’s promotion of local exchange service competition will likely mean the eventual disintegration of distinctions, created by the MFJ, between separate “local” and “long distance” telephony markets. The U.S. market is currently in a transition to a reunified market, but it is still possible, for now, to distinguish between the two separate markets that developed after 1984.

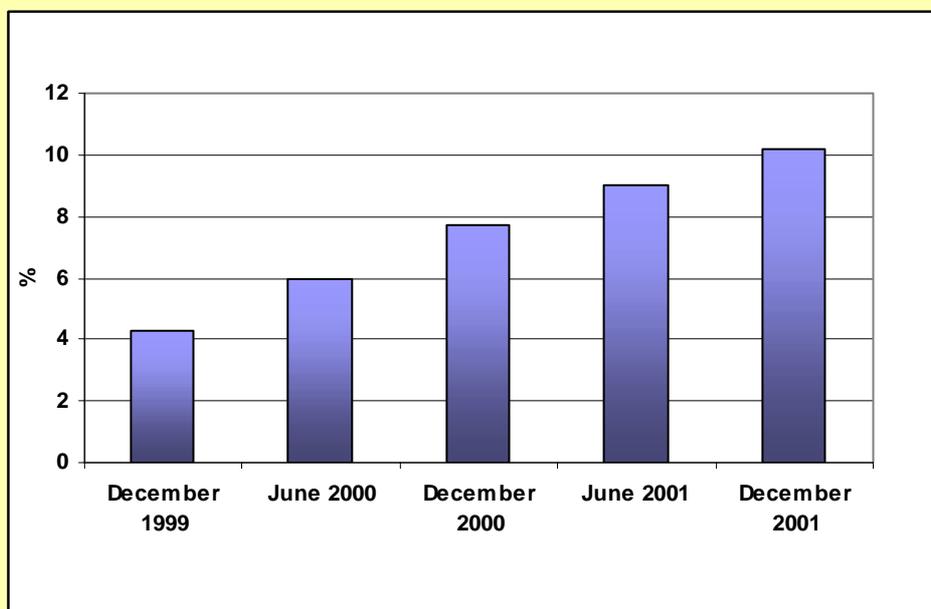
3.2.1 Wireline Telephony

3.2.1.1 Local Exchange Service

By the end of 2001, competitive local exchange carriers (“CLECs”) were providing 19.7 million switched access lines in the U.S.—a fairly substantial achievement in raw terms. But that figure represented only about 10.2% of the total of 192 million switched access lines in the U.S.³⁰ Even so, it reflected steady growth in market share, as determined by the number of lines served.³¹ The number of lines served by CLECs grew by 14% in the second half of 2001.³² In terms of revenues, the CLECs’ share was similar, rising from 5.8% (\$6.3 billion) in 1999 to 8.9% (\$10.7 billion) in 2000.

Only 1% of U.S. telephone access lines (2.2 million) were provided over coaxial cable TV plant by the end of 2001, although such lines amounted to 11% of CLEC access lines.³³

Figure 3.1: CLEC Market Share Growth
Growth in CLEC Market Share local services market, 1999-2001



Source: Local telephone competition: Status as of December 2001, Ind. Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission

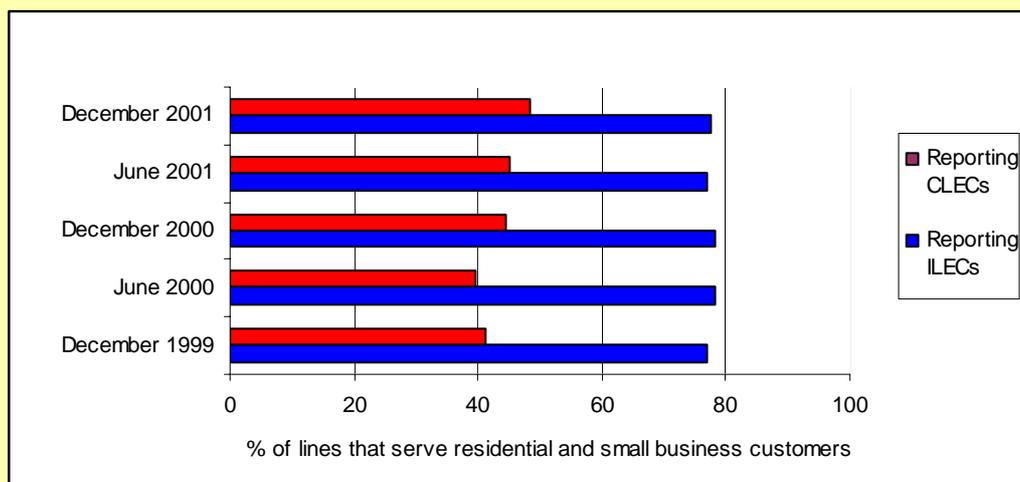
On a more granular level, residential and small business customers continue to be a minority of the CLECs’ customer bases (48.3%), while the majority of the incumbent local exchange carriers’ (“ILECs’) customers were in that category (77.6%). The percentage of ILEC customers who were residential or small business customers remained virtually unchanged over a two year period, while the CLECs registered a slight uptick in the percentage of such customers.³⁴

In the U.S. regulatory structure, CLECs have three ways in which to construct their competitive networks:

- They can construct new networks entirely with their own transmission and switching facilities (the “facilities-based” approach);
- They can take advantage of unbundled network access that incumbents must offer to put together their own leased networks (the unbundling approach); or
- They can resell the incumbents’ retail offerings, at a wholesale discount (the “total service resale” approach).

Figure 3.2: Growth in CLEC Residential and Small Business Lines

Slight growth in the percentage of CLEC lines provided to residences and small businesses, 1999-2001



Source: *Local telephone competition: Status as of December 2001, Ind. Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission*

The FCC has, to this point, broadly interpreted the rights of CLECs to engage in the unbundling approach. As a result, a CLEC can lease all of the individual elements of a network, at cost, and “assemble” them into a ready-made leased network, which has come to be known as the “unbundled network element platform” or UNE-P. In practical terms, this amounts to a form of resale, with the wholesale inputs provided at cost.

Data provided by the FCC indicate that CLECs are making increased use of UNE-P as a market-entry strategy. The number of end user access lines CLECs provided using their own facilities-based networks has remained roughly constant since the end of 1999, at about one-third of their total access lines. But the mode of providing the remaining two-thirds of access lines has shifted significantly in the past two years. In 1999, about 43% of CLECs lines were provided by total service resale, while only 24% were provided using unbundled network elements. Two years later, those percentages had more than reversed: 22% of CLEC lines were provided through total service resale, while nearly 48% were provided through unbundling, including UNE-P.³⁵

UNE pricing is based on cost, which is computed according to a long-run incremental cost (LRIC) model variant known as “total element long run incremental cost” or TELRIC. Total service resale, by contrast, involves a much narrower profit margin. Put simply, it costs less to lease each piece of a network at cost under UNE-P than the CLEC must pay as a reseller, even with a wholesale discount. Over the past two years, UNE prices, as determined by state regulatory commissions, have declined consistently, enhancing the cost advantage in opting for the UNE-P entry model.

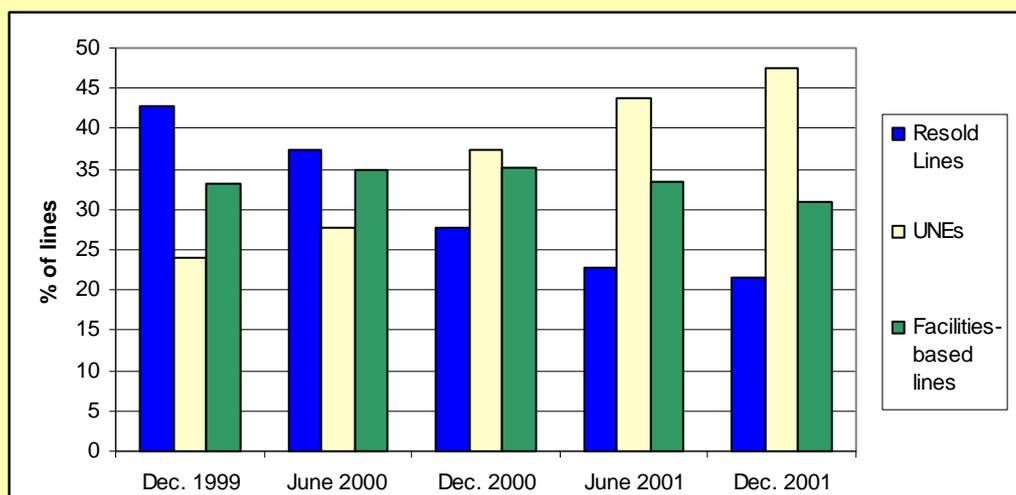
3.2.1.2 Long Distance Telephony

By 2000, 782 companies were classified as toll carriers in the United States, meaning that the provision of long distance service was their primary business.³⁶ The telecommunications industry garnered in excess of \$109.6 billion in toll service revenues in 2000, the last complete year for which the FCC provides statistics.³⁷ That figure represented growth over the previous year, in which the total toll service revenues were \$108.2 billion. But the rate of growth had slackened significantly from previous years, in which the industry had added an average of almost \$4 billion each year.

Among the hundreds of long distance carriers, the vast majority were smaller, niche resellers. The three largest carriers remained AT&T (\$37.6 billion in revenue), WorldCom subsidiary MCI (\$22.6 billion) and Sprint (\$9 billion). In 1984, just after Divestiture, AT&T had a market share of 90.1% among long distance carriers, with MCI and Sprint trailing at 4.5% and 2.7%, respectively. By 2000, AT&T's market share stood at just 38%, with MCI and Sprint commanding 22.4% and 9%, respectively, and all other carriers atomizing the remaining 30.7%.³⁸

Figure 3.3: CLEC Market Entry Strategies

Shifts in unbundling (UNE-P), resale, and facilities-based entry, 1999-2001



Source: Local telephone competition: Status as of December 2001, Ind. Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission

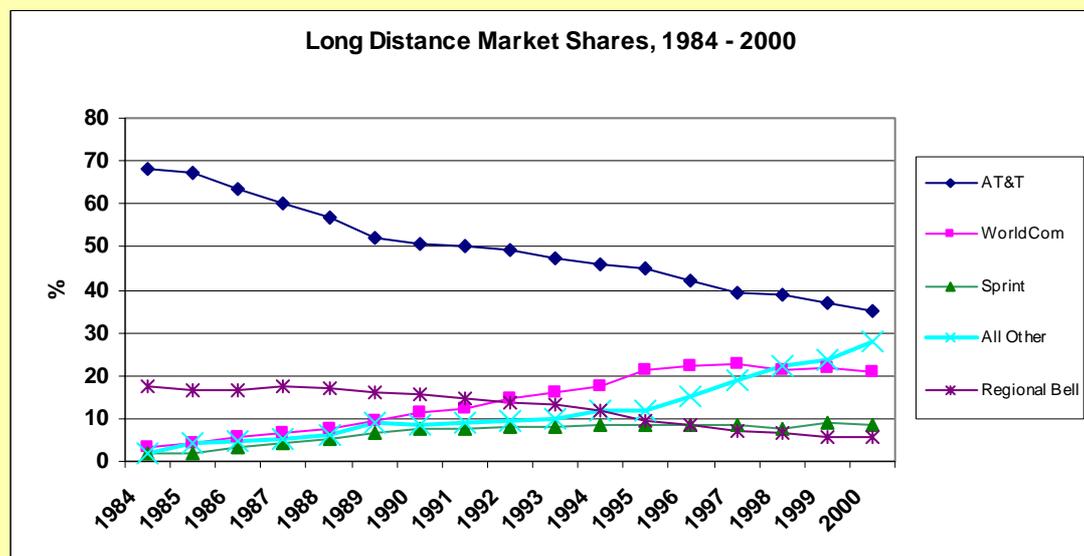
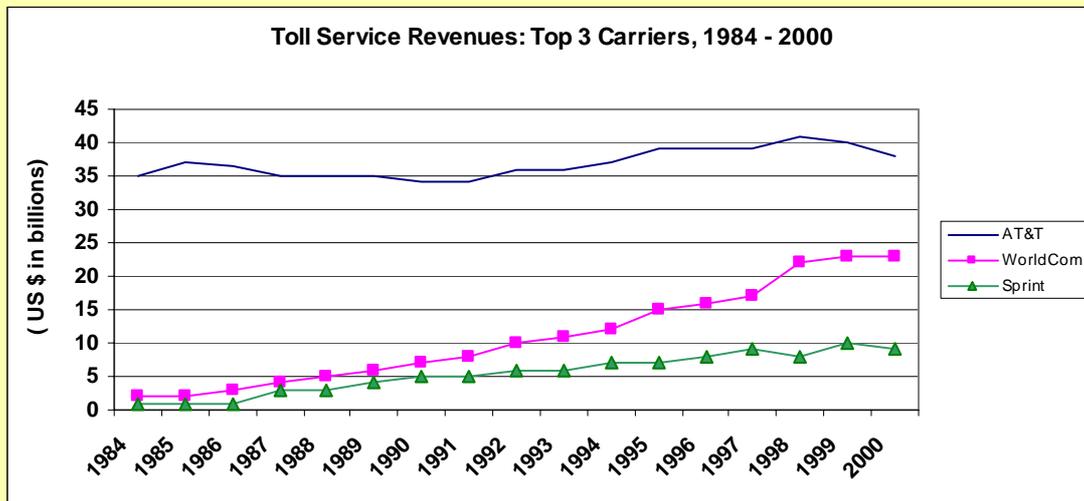
The long distance market is, however, changing rapidly due to regulatory developments, including interLATA market entry by the Bell operating companies. Ultimately, the long distance market will likely cease to exist as an identifiable market segment, due to the combined effects of Bell company entry (thus reunifying the vertical split in the telephony market), wireless substitution (see Section 3.2.4) and, potentially, IP telephony.

3.2.2 Wireline Broadband Services

The widespread practice of flat-rated monthly pricing for unlimited local calling fueled a healthy dial-up Internet access industry in the United States in the 1990s. With time-insensitive local calling, most Americans pay only monthly fees to Internet access providers for narrowband connections. But dial-up Internet access is a fairly saturated market and is widely seen as plateauing this year at roughly 54 million users.³⁹ There is a growing market, however, for broadband Internet connections, and the FCC has made deployment of broadband networks and access platforms one of its top priorities.⁴⁰

The FCC classifies broadband transmission services in two categories. “High-speed” services are those with a capacity of more than 200 kilobits per second (Kbit/s) in at least one direction. “Advanced” services are those with a capacity of more than 200 Kbit/s in both directions. At this juncture, despite hopes that fixed wireless and satellite services will become a viable “third wire” market, there are essentially two platforms for mass market (residential and small business)

Figure 3.4: Toll Service Revenues and Long Distance Market Share
Growth in toll service revenues and long distance market shares 1984-2000



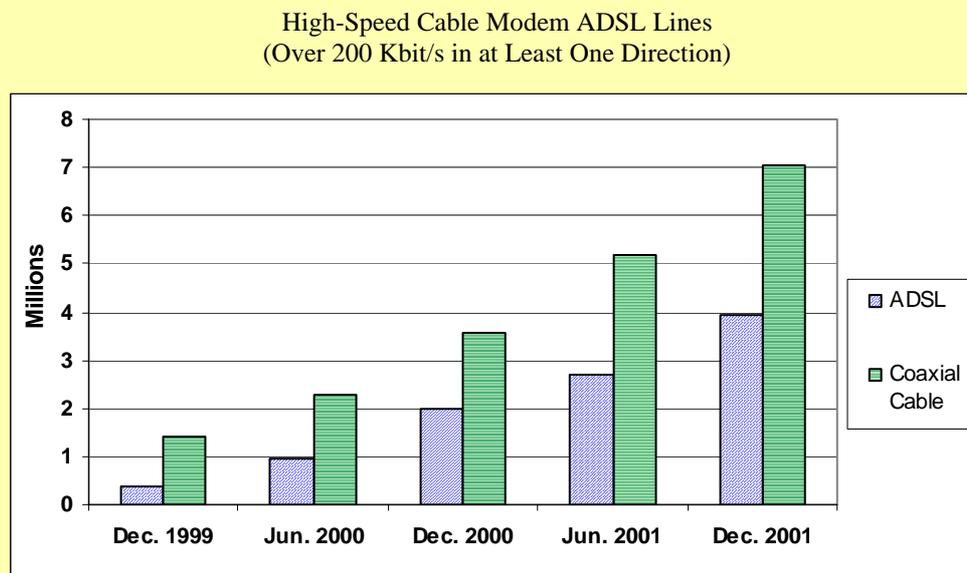
broadband services: cable modem service and ADSL.

The total number of high-speed lines in the U.S. increased by 33% during the second half of 2001 alone, rising from 9.6 million to 12.8 million lines. This followed an even greater increase, of 36%, during the first half of the recession year. Of the 12.8 million high-speed lines, 7.4 million were “advanced” service lines and 11 million were provided to residential and small business customers.⁴¹ All told, the number of high-speed lines had grown by roughly 10 million in just two years. Direct high-speed fiber connections totaled a little less than 500,000 at the end of 2001, and growth in such links had declined from 21% in the first half of the year to 9% in the second half.⁴²

Cable modem service represented the largest segment of the consumer market, constituting 7.06 million high-speed lines at the end of 2001, compared with 3.95 million ADSL lines. There was evidence, however, that momentum had begun to shift somewhat toward faster ADSL growth. During the first half of 2001, ADSL lines grew by 36%, while cable modem lines grew by 45%. In the last half of the year, however, the trend reversed, with ADSL growing 47% and cable modem lines growing 36%. In any case, head-to-head competition between ILECs and cable companies is a significant reality in the U.S. broadband market.

The ADSL market is dominated by ILECs. The Bell operating companies provided 90.3% of all ADSL lines at the close of 2001, while other incumbent (but not Bell company) LECs provided some 7%, leaving CLECs with just 2.7% of the ADSL market. But when all types of high-capacity lines are considered—including ADSL and coaxial cable (cable modem) lines—the Bell companies hold only 34.5% of the broadband market, compared with 62.4%, combined, for CLECs, cable operators and others.⁴³

Figure 3.5: High-Speed Internet Access Lines
Growth in High-Speed Internet Access Lines, 1999-2001



Percentage Change

| | Dec. 2000 - June 2001 | June 2001-Dec. 2001 |
|---------|-----------------------|---------------------|
| ADSL | 36% | 47% |
| Coaxial | 45% | 36% |

3.2.3 Terrestrial Wireless Services

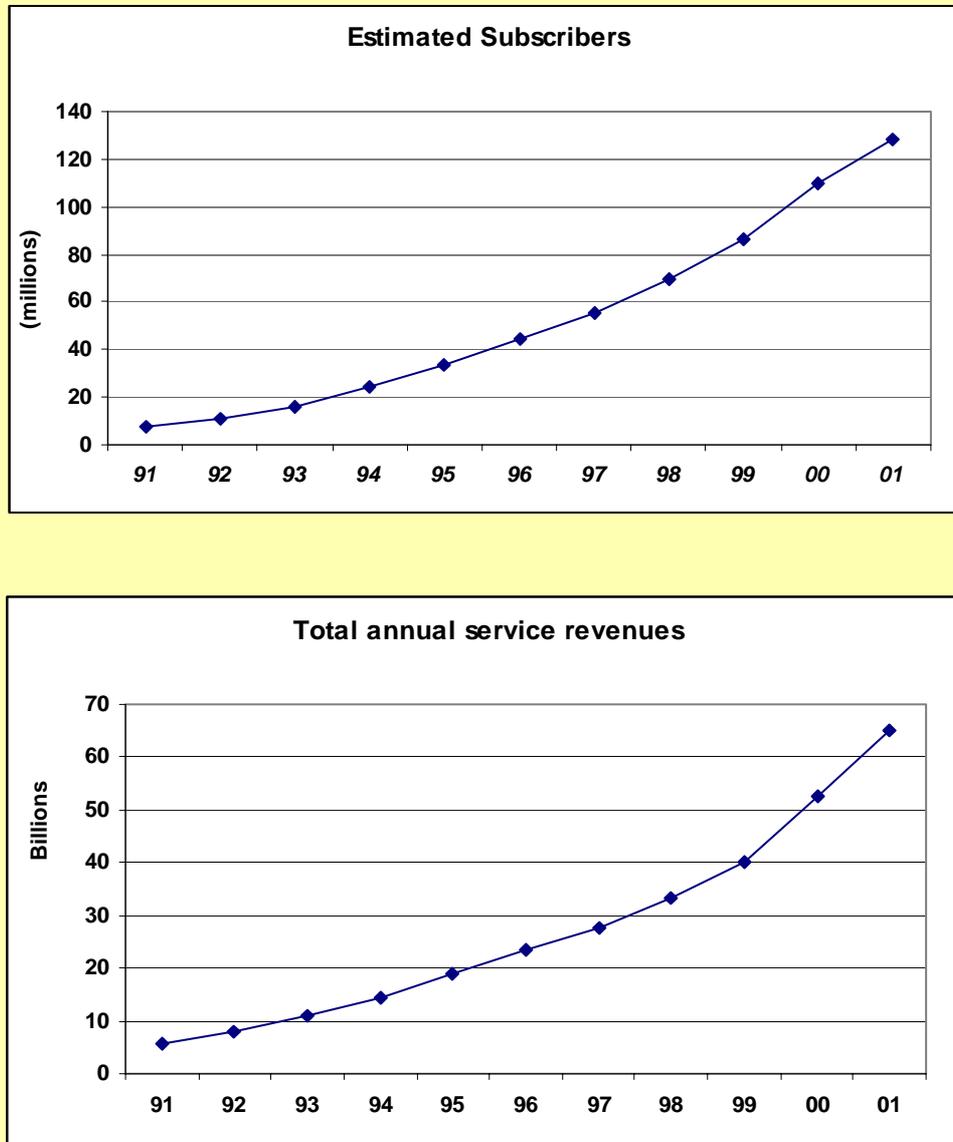
3.2.3.1 *Mobile Voice Services*

The mobile voice market has continued to grow, generating more than \$6.5 billion in revenues during 2001. Subscribership increased from 109.5 million to 128.5 million during the year, resulting in a nationwide penetration rate of about 45%—leaving clear room for continued growth and expansion.⁴⁴ Moreover, the industry had converted 80% of its customers to digital networks, up from 72% at the end of 2000.

The U.S. mobile sector is among the most competitive and least concentrated in the world. More than 229 million Americans live in areas where they have access to at least five competing mobile service providers, and 151 million—more than half the population—live in areas with six different competitors. The U.S. regulatory structure offers three different licenses for mobile services: cellular, personal communications service (PCS), and “specialized mobile radio” or “SMR.” The first two utilize cellular architectures, while the third license is for trunked radio operations. By the end of the 1990s, any given geographic area could have up to eight cellular-based carriers (2 older cellular, plus up to 6 PCS), not counting SMR carriers such as Nextel.

In 2002, there are six mobile telephony providers that are considered nationwide carriers, because they control licenses in many areas across the country, giving them something like a national “footprint.” Those are AT&T Wireless, Sprint PCS, Verizon Wireless, VoiceStream, Cingular Wireless, and Nextel. It is fairly common for one of these national carriers to announce agreements to purchase smaller license holders, or for smaller, regional network operators to consolidate.⁴⁵ Moreover, several of the largest national networks consist of “families” of affiliates rather than a single company. These affiliate networks include those of AT&T Wireless, Sprint PCS and Nextel.

Figure 3.6: U.S. Mobile Market Growth 1991-2001
 Growth in subscribership and revenues over the last decade.



Source: CTIA's Semi-Annual Mobile Telephone Industry Survey

The mobile market has reached a certain level of maturity, with declining prices and more than 30% of subscribers changing carrier each year.⁴⁶ According to the FCC, the industry added fewer new subscribers in 2001 than it had in 2000. But industry sources indicate that minutes of use increased anywhere from 22% to 51% during 2000.⁴⁷ Average revenue per unit (“ARPU”) had increased 20% by the end of 2001, to \$47.37, despite continuing overall price decreases. The FCC believed this ARPU revival could be a function of either increased usage or somewhat higher-priced calling plans.⁴⁸ Many of those plans emphasized “unlimited” long distance calling, potentially draining minutes of use from wireline long distance carriers (See Section 3.2.4).

3.2.3.2 Mobile Data Services

The FCC estimates that by the end of 2001, there were between 8 million and 10 million mobile Internet users, a relatively small but potentially increasing market. Indeed, that figure represented a jump from roughly 2.5 million mobile Internet users a year earlier.⁴⁹ Those estimates would include users of all kinds of wireless devices, including “personal digital assistants” (PDAs). Several mobile carriers have embarked on network upgrades and initiated “2.5G” services based on cdma2000 1xRTT technology (these include Verizon and Sprint PCS). AT&T Wireless, VoiceStream and Cingular have deployed GPRS upgrades and plan eventually to migrate to EDGE and W-DMA technologies.⁵⁰

Unlike many parts of Asia and Europe, there has been no watershed auction of 3G licenses in the United States. The wireless industry spent much of 2001 and early 2002 pressing hard for the FCC and its regulatory counterpart, the Commerce Department’s National Telecommunications and Information Administration, to agree on a program to allocate spectrum domestically for 3G services. This effort was complicated by the fact that the spectrum targeted by the industry, at 1755-1850 MHz, was already allocated to federal government usage—with intensive military uses.

3.2.4 Intermodal Competition

The competition between the Bell companies’ ADSL offerings and the cable operators’ cable modem services was one example of competition between different network platforms. Such “intermodal” competition was an increasing subject of debate in proceedings before the FCC and in Congress in 2002. As it became apparent that competition among incumbent and competitive telephone companies would develop at only a glacial pace, policy-makers increasingly touted the possibility that competitive telephony and broadband services would be offered by cable operators, fixed wireless providers, satellite companies and 2.5 G mobile data networks. Of these alternative providers, however, most had miles to go before matching the market take-up of broadband ADSL and cable modem offerings.

Meanwhile, there was growing evidence (although much of it remained anecdotal) that the mobile wireless industry had finally begun to erode wireline telephony market share. Due to the ubiquity of land-line networks, “called party pays” pricing and service quality, mobile phones had not in the past been widely viewed as “substitutable” for wireline service in the U.S. But with 61% of all U.S. households now possessing at least one wireless handset—and with many mobile pricing plans offering packages of “free” long distance minutes—mainstream and trade press reports began suggesting in 2001 and 2002 that many American consumers were abandoning wireline long distance carriers and, in some cases, even ceasing to use wireline phones entirely.

In its 2002 report on wireless competition, the FCC noted analysts’ estimates that 3-5% of wireless subscribers used mobile phones as their sole voice network connections.⁵¹ Further estimates, based on polling, appeared to indicate that almost 20% of Americans viewed mobile phones as their “primary” phones, and a similar percentage had replaced a “significant” amount of wireline usage with wireless usage. Moreover, a top executive at Verizon reported that the number of access lines serviced by Verizon, SC and BellSouth dropped by 2.5 million (3%) in 2001—a trend he attributed to wireless substitution.⁵² If verified by official statistics, this trend would mark a significant U.S. market shift.

4 The Legal and Regulatory Environment

4.1 The Legal Foundations of Competition Policy

There are three key aspects of U.S. competition policy, as it pertains to telecommunications. *First*, there is no single policy, created and implemented at a single point in time. Competition policy has evolved continuously over some 100 years of legislation and common law jurisprudence. *Second*, there is no single agency or institution in charge of competition policy. Rather, it is the result of a constant interplay between multiple agencies and industry actors, at multiple levels of jurisdiction, both horizontally (within the federal government) and vertically (between state, local and federal governments).

Third, the U.S. system mixes both broad competition law, which applies to any economic activity, with sector-specific regulation. Broad competition policy evolved first in the form of “antitrust” laws designed to prevent large corporations or trusts from using market concentration to gain and abuse market power. The key federal antitrust laws were in place for more than two decades before Congress enacted the sector-specific 1934 Communications Act, creating the FCC to regulate telecommunications in the public interest.

Beyond Washington, D.C., the state governments maintain their own multi-sector utility regulatory agencies and also enforce state consumer protection laws. And watching over all of these activities are the state and federal courts, which hear civil and criminal claims and may review and overturn decisions of administrative agencies such as the FCC.

4.1.1 The Sherman and Clayton Antitrust Acts

The Sherman and Clayton Acts provide the basic antitrust legal framework in the United States. They prevent two or more entities from engaging in collusion to restrain trade, they prohibit the creation or maintenance of monopolies, and they allow the Justice Department and the Federal Trade Commission to review and file suit to block mergers that may harm competition. Section 1 of the 1890 Sherman Act (15 U.S.C. § 1) provides that:

“Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony. . .”⁵³

This provision gives the Justice Department the ability, if it should require, to file criminal charges against two or more entities for conspiring or colluding to restrain trade. Where no criminal intent to violate the Sherman Act is found, the Justice Department may nevertheless file a civil lawsuit against actions that result in restraint of trade. Meanwhile, Section 2 of the Sherman Act prohibits one or more entities from attempting to form or preserve a monopoly in restraint of trade:

“Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony. . .”⁵⁴

The 1914 Clayton Act buttresses the Sherman Act by, among other things, generally prohibiting one company from buying or merging with another company where the intent or effect is to substantially lessen competition or to create a monopoly. Section 7A of the Clayton Act, added through the Hart-Scott-Rodino Act of 1976, requires parties planning a merger to notify the government, then observe a waiting period prior to completing the merger, allowing a review by the Justice Department or the Federal Trade Commission.⁵⁵

These laws form the basis for government efforts to protect competition in the U.S. market as a whole. Moreover, as discussed in Section 4.2.2.1, the Department has specialized advisory role, through the 1996

Telecommunications Act, in evaluating the extent of control exercised by the Bell operating companies over essential “bottleneck” local network facilities.

4.1.2 Sector-Specific Regulation

4.1.2.1 The Communications Act of 1934

By 1933, President Franklin D. Roosevelt was seeking a more efficient means to regulate all forms of electronic mass communication then prevalent—broadcasting, telephony and telegraphy.⁵⁶ The creation of the FCC the following year effectively marked the beginning of comprehensive federal regulation of telecommunications. The FCC received a broad mandate to regulate all “interstate and foreign commerce in communication by wire and radio.”⁵⁷

The Communications Act was divided into sections that largely corresponded to the communications market segments of the day. Title I established the FCC and gave it its mandate. Title II established authority over telecommunications common carriers, based largely on the regulatory principals over transportation common carriers (e.g., shipping companies or railroads) regulated by the Interstate Commerce Commission. The concept of common carriage, in fact, was already well established in U.S. common law (See Box 4.1).

Box 4.1: A Short History of Common Carriage

The concept of common carriage has its roots in English common law and practice. The development of common carriage allowed the continuance of public services in private, commercial hands, while granting the government some say over how services should be offered and who should be able to receive them.

The earliest common carriers were created when the British crown awarded an exclusive monopoly to a company operating a facility such as a ferryboat, wharf or printing press.⁵⁸ In return for royal favor in the form of an exclusive franchise, the monopolist was required to charge only “reasonable rates,” to offer adequate and reliable service, and to accept all customers on the same terms, without discrimination. In return for losing the ability to weed out those whom they might not wish to serve, common carriers enjoyed certain legal privileges, including a limit on their liabilities.

The tradition of common carriage was brought from Great Britain to America, where it was established in the fields of shipping, transportation and, eventually, communications.

Following this common law foundation, the Communications Act required telephone companies holding themselves out as common carriers to provide service upon request, on nondiscriminatory terms and pursuant to “just and reasonable” charges and terms. Moreover, these “carriers” were required to file publicly with the FCC tariffs listing their charges and terms of service.⁵⁹ Through Title II, the FCC could regulate carriers’ rates and their interactions with their customers and one another, in order to prevent unreasonable and discriminatory activity and to uphold the public interest.

The framework established by the Communications Act, with its divisions based on the market structure of 1934 (Titles III and VI pertain to wireless and cable TV services, respectively) remains largely intact today. Alongside the U.S. District Court’s adjudication of the AT&T Consent Decree, the Act provided sufficient foundation and context for the development and implementation of policies to promote competition throughout the 1980s and into the early 1990s.

Box 4.2: The Legacy of 'Basic' and 'Enhanced' Services

The FCC first addressed the “convergence” of computing and voice services in the mid-1960s, when it originated its *Computer Inquiries*. In its *Computer I* proceeding, the Commission determined that it would not be in the public interest to regulate computer data processing services, since those offerings were deemed to be “essentially competitive.”⁶⁰

In the *Computer II* proceeding begun in 1976, the Commission affirmed its decision not to regulate data processing, and further, it defined two types of telecommunications services: “basic” and “enhanced.” Basic services were traditional common carrier services that offered transmission capacity for the movement of information. Enhanced services were offered over common carrier facilities but went beyond mere transmission to encompass “computer processing applications that act on the format, content, code, protocol, or similar aspects of the subscriber’s transmitted information . . . or involve subscriber interaction with stored information.”⁶¹

In the 1996 Telecom Act, Congress perpetuated the legacy of the basic v. enhanced split in creating the following definitions:

Telecommunications — the “transmission, between or among points specified by the user, of information of the user’s choosing, without change in the form or content of the information as sent and received.”

Telecommunications service — “the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used.”

Information service — “the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing or making available information via telecommunications . . .”

Basic services have come to be known as “telecommunications” or, when offered directly to the public, “telecommunications service.” Enhanced services are now known as “information services” and include Internet access offerings and other data processing services. As a result of the *Computer Inquiries*, Bell operating companies were subjected to network access obligations designed to ensure that competitive information service providers have nondiscriminatory access to underlying telecommunications used in the provision of information services.⁶²

4.1.2.2 *The Telecommunications Act of 1996*

In enacting the Telecommunications Act—the first significant overhaul of the 62-year-old Communications Act—Congress had several major goals, including:

- The promotion of competition in all markets, including local exchange markets,
- The deployment of advanced communications networks; and
- The rationalization and enhancement of universal service programs.⁶³

Among other things, the Telecom Act established a clear mandate and federal policy for competition in all telephony networks, not just the long distance market, which had been opened to competition by the 1980s. The key pro-competitive provisions of the Telecom Act include:

- Sections 251 and 252 (interconnection and unbundling). All carriers must interconnect with one another. All local exchange carriers (LECs) must allow resale, number portability and access to rights of way and must compensate each other for the termination of calls. In addition, incumbent LECs (ILECs) face more stringent requirements because of their previous monopoly status and control over “bottleneck” essential network facilities. These ILEC obligations include unbundling access to UNEs (unbundled network elements) at cost; offering services for resale at a specified wholesale discount; and allowing competing carriers to “co-locate” equipment in ILEC central offices. State regulators were given the duty of mediating and approving interconnection agreements and UNE prices.

- Section 254 (universal service). The FCC was required to make “implicit” subsidies (e.g., cross-subsidization of local rates from long distance access charges) explicit through one or more fund mechanisms. The Commission also was required to ensure that schools, libraries and rural health care providers have sufficient access to “advanced” telecommunications capabilities.
- Section 271 (interLATA market entry). A mechanism was established for Bell operating companies to seek permission, on a state-by-state basis, from the FCC to provide interLATA long distance services in their home regions.⁶⁴ The Bell companies must prove they have complied with requirements, including a 14-point checklist, to allow competition in the local exchange markets.
- Section 272 (Bell company structural separation). Bell operating companies can only provide certain services (e.g., in-region interLATA services, once authorized) through creation of a separate affiliate to offer those services. This section imposed certain structural and transactional separation requirements upon the Bell companies and their affiliates in an effort to establish an “arm’s length” relationship that would prevent undue discrimination by the Bell operating companies in favor of their affiliates and against competitors.
- Section 706 (advanced service deployment). The FCC and state commissions must “encourage the deployment on a timely basis” of “advanced telecommunications capability,” to all Americans.

The Telecommunications Act is notable for what it did—and did not do—to alter the framework of sector-specific competition policy. It did not, for example, attempt to address convergence or intermodal competition in a comprehensive manner, although it did eliminate barriers that had prevented cable operators from offering telephony. The Telecom Act largely maintained the separate regulatory treatment of different industry sectors, pursuant to the existing Titles of the Communications Act. As a result, the FCC was given no clear direction on how, or even whether, to regulate Internet access or IP telephony offerings on different, competing network platforms.

What the Telecom Act did do, however, was to enshrine in law the policy of asymmetric regulation that had been a core facet of the MFJ. As a statutory matter, the incumbent LECs were singled out for greater regulatory scrutiny and restrictions, based upon their control of “bottleneck” (essential) local loop and other facilities. Through the unbundling mandate of Section 251, in particular, ILECs were forced to allow competitors to obtain access to their networks—not at market-based prices, but at cost. No such requirement was imposed upon competitive network operators.

Moreover, even among ILECs, the Telecom Act imposed further restrictions on the Bell operating companies—a direct legacy of the MFJ. Through Sections 271 and 272, the Bell telephone companies faced line-of-business restrictions and structural separation requirements that not only did not apply to new market entrants, they did not apply to GTE or other independent incumbents that had been operating as monopolies in local service markets for decades.

Not only did the Telecom Act preserve the differing approaches to regulating different industry segments, it actually enhanced them through asymmetric regulation. This resulted from a combination of three factors: (1) the desire to refrain from regulating (and therefore squelching) growth technologies such as the Internet; (2) a judgment, based on competition policy principles, to impose more stringent regulation on incumbent local service providers because of their ongoing market power; and (3) simple legislative inertia, which led to the preservation of regulatory regimes more closely linked to the market realities of 1934, 1984 or 1994, than of 2004.

4.1.3 Federal v. State Responsibilities

Among the central realities of U.S. telecommunications law is the issue of federalism. Federal law may allow a federal agency, acting within the scope of its congressionally delegated authority, to preempt state regulation in some cases.⁶⁵ Moreover, the Communications Act grants the FCC plenary jurisdiction over *interstate* networks and services, as well as international telecommunications to and from the United States.

Box 4.3: One Network, Two Jurisdictions

Is it possible to determine what part of the U.S. network is interstate and what part is intrastate—and if not, does the federal government have preeminence over state governments? This question, which is at the heart of U.S. federalism, has been the subject of several key judicial decisions over the past century.

The *Shreveport Rate Case*, 1914 — This case actually involved railroads, but it established the right of the federal government to direct a state to raise intrastate rates in order to prevent discrimination in favor of customers of purely intrastate services.⁶⁷ In 1934, however, Congress specifically stated that the FCC would have no authority over intrastate services, nullifying the effect of *Shreveport* in telecommunications regulation.⁶⁸

Smith v. Illinois Bell Telephone Co., 1930 — This case required the separation of a telephone company’s costs between intrastate and interstate, overturning a state commission’s decision assigning all local plant costs to the intrastate jurisdiction.⁶⁹ In the wake of this case, the FCC asserted responsibility for separating those costs out.

North Carolina Utility Commission v. FCC (NCUC I), 1976 and *NCUC II* 1977 — In cases involving the FCC’s deregulation of customer premises equipment (CPE), the federal Fourth Circuit appeals court upheld the FCC’s preemption of state orders preventing the attachment of privately purchased CPE to the public network unless they were used solely for interstate communications. The court reasoned that any such state prohibition would interfere with the FCC’s federal goals for CPE deregulation. Thus, state decisions could be preempted wherever they would affect interstate telecommunications.

Louisiana Public Service Commission v. FCC, 1986 — In a case involving depreciation rates, the Supreme Court ruled that the jurisdictional separations process allowed the maintenance of a *dual system* of regulation under the Act and that states were “sovereign” within their intrastate spheres. This eroded the FCC’s preemption ability in cases where state jurisdiction was clear. The court ruled that preemption could take place only if it was impossible to sever interstate and intrastate interests or where a state decision would negate or frustrate a federal interest.⁷⁰

But the state governments, through their legislatures and regulatory commissions, exercise strong authority over *intrastate* services.

The problem with this bifurcated approach, of course, is that some of the same network facilities are used to provide both intrastate and interstate services. Both are originated and terminated over the same local loops. In theory, this implies a shared jurisdiction over network facilities used for telecommunications.⁶⁶ Cooperation among federal and state regulators is often difficult, however, and jurisdictional questions are constantly being aired, tried and contested in state and federal courts, with the result that jurisdictional issues are commonly settled as a matter of judicial precedent. New issues constantly arise, necessitating additional judo matches over whether a certain service is subject to state or federal jurisdiction.

The Telecom Act, however, attempted to spell out the roles of state regulators in competition policy, assigning them specific tasks in implementing local exchange and interLATA entry policies. State regulators, for example, are charged with mediating and approving interconnection agreements pursuant to Sections 251 and 252, effectively giving them pricing authority over interconnection and unbundling. The courts have ruled that the FCC has authority only to set national guidelines for interconnection and UNE pricing; states are expressly given the right to set the actual rates. Also, the state regulatory commissions have a key role in vetting interLATA applications before Bell companies file them with the FCC. As a result, state regulators have become instrumental in designing mechanisms to ensure compliance with Section 271.

To cut through jurisdictional gordian knots, several mechanisms have been developed to bring state and federal regulators together in consensus decisions. The FCC may assign cross-jurisdictional issues to “joint boards” composed of federal and state regulators, who then frame recommendations to the FCC. Universal service issues, for example, have long been subject to joint-board recommendations, because of the core impact they have on common facilities for both intrastate and interstate services.

Because of the Telecommunications Act, cooperation among state and federal regulators has become more vital than ever.⁷¹ From the federal point of view, state regulators are instrumental in helping to implement

federal policies. Because the states differ demographically, economically and geographically, state regulators often are closer to local conditions and know better how to achieve implementation. For their part, state regulators note their ability to pioneer new policies and creative regulatory techniques. They view the jurisdictional divide as a creative one, allowing a dialectical interplay between federal and state officials not just on implementation, but on policy formulation, as well. Nonetheless, legal jockeying over jurisdictional questions means that creative tension is a constant backdrop to competition policy.

4.1.4 Ex-Ante v. Ex-Post Approaches

Because the U.S. competition policy approach involves both antitrust and sector-specific regulation, there is a balance between *ex-ante* and *ex-post* approaches. FCC and state regulation is traditionally *ex-ante*. Until the advent of price cap regulation in the late 1980s, many carriers (including incumbent LECs) were governed by detailed “rate-of-return” price regulation, at both state and federal levels. Many small incumbent telephone companies continue to be subject to rate-of-return regulation today. Moreover, the Telecom Act’s restrictions and obligations (unbundling and collocation, for example) are clear examples of *ex-ante* regulations.

By contrast, antitrust regulation—with the exception of merger pre-notification and review—involves *ex-post* enforcement. Justice Department officials can investigate violations of the Sherman and Clayton Acts only after those violations have occurred. Prevention of collusion and price-fixing relies on the threat of law enforcement or civil litigation, not administrative fiat. The Justice Department can govern future behavior only by exacting judicial remedies or by obtaining agreement of parties through consent decrees.

4.2 Centers of Power and Authority

As the previous section indicated, the evolution of competition policy in the U.S. has meant a wide dispersion of responsibility for various facets of market supervision. Many agencies have a role in some piece of competition policy-setting, implementation and enforcement. This section will identify the various players.

4.2.1 Congress and the FCC

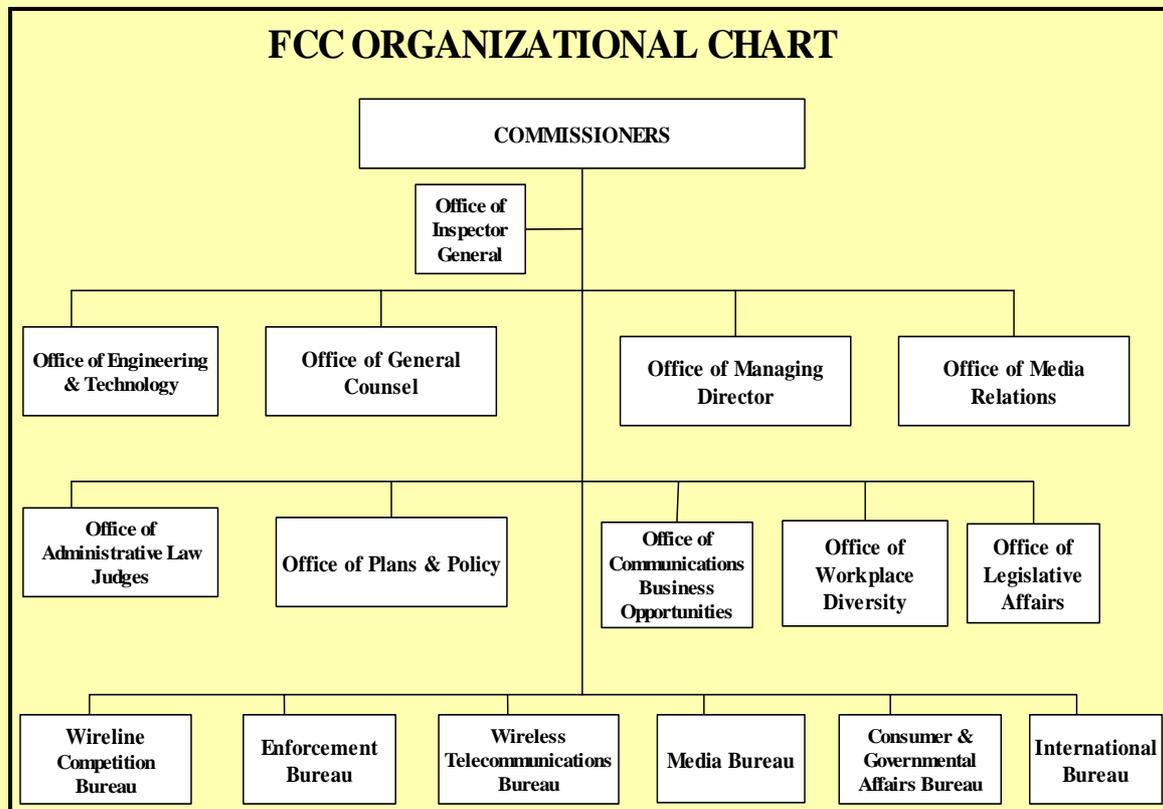
Congress is the primary architect of telecommunications policy. Both houses of Congress have subcommittees devoted to the consideration of new legislation. These committees serve as the focal points of intensive lobbying throughout most of each legislative session in Washington. In the end, few stand-alone bills survive the legislative process during each two-year congressional cycle, although some provisions may survive as legislative “riders” attached to general budget authorizations. But by just considering various bills, Congress maintains its role as king-maker within the policy community. Often, the mere threat of new legislation will crystallize support and opposition within the industry and shift the focus of government policy discussions.

Part of the reason for this is that the FCC is a congressionally authorized independent agency. It is not part of the Executive Branch and thus does not answer directly to the White House, as do the Justice and Commerce Departments.⁷² Individual members of Congress can, and frequently do, send letters to the FCC’s Chairman expressing their opinions and the needs of their constituents regarding issues that may come before the Commission. Congress cannot directly countermand FCC decisions (which can only be reviewed by a federal appeals court), but it can exercise considerable influence over the FCC through its ability to enact legislation, its ability to require the agency to answer inquiries and deliver reports, its control over the FCC’s budget, and its approval of nominations to the Commission.

As an independent agency, the FCC is closely governed by the Administrative Procedure Act (APA), which requires it to base decisions on a public record compiled either through hearings or public comment solicitations. In many cases, meetings held to discuss pending proceedings before the commission must be publicly disclosed and described in the public record. Unlike certain Executive Branch agencies, the FCC has the ability to issue orders and rulings with the force of law. As an expert agency of primary jurisdiction,

the FCC’s decisions are reviewed by federal appeals courts, not district courts, which are the primary-level federal courts for most civil and criminal cases.

Figure 3.7: FCC Organizational Chart



Source: www.fcc.gov

4.2.2 The Executive Branch and other Independent Agencies

The various departments of the Executive Branch influence telecommunications policy in two ways: through specific policy-making and advisory duties and as large-scale users of telecommunications equipment and networks. The Defense and Transportation Departments, for example, have no role in regulating communications, but as users of spectrum and buyers of network equipment and services, they may exercise a strong influence on policy issues such as spectrum management, equipment standards or network security. In addition, the FCC is required to consult with Executive Branch departments on some actions, such as granting or transferring international service or wireless licenses, which could affect national security, trade or other national interests.

4.2.2.1 The Justice Department

The Justice Department, through its Antitrust Division, acts as the government's primary watchdog in enforcing the Sherman and Clayton antitrust laws in cases involving telecommunications carriers. It may bring criminal cases or file civil suits whenever it believes companies or individuals have engaged in collusion to restrain trade or to prevent monopolization. For example, during the 1990s, the Department carried out an investigation into several companies it believed were engaging in efforts to fix bids in spectrum auctions carried out by the FCC.

Also, pursuant to Section 271 of the Communications Act (as amended) the FCC is required to consult with the Department before granting any Bell company permission to offer originating, in-region interLATA. The Department therefore maintains a staff capable of reviewing and analyzing data concerning competition in local exchange markets throughout the country.

Perhaps the strongest role played by the Justice Department, however, is in reviewing telecommunications mergers. Through the Hart-Scott-Rodino Act, mergers with monetary values above a certain threshold must be reported to the government, touching off a pre-merger review. The Justice Department's horizontal merger review guidelines will be outlined in detail in Section 5.

4.2.2.2 The Federal Trade Commission

The FTC, an independent Federal agency, is charged with preventing unfair and deceptive market practices by companies operating in the United States. It also maintains a Bureau of Competition, which seeks to prevent market practices that restrain competition. Like the Justice Department, the FTC reviews proposed mergers under the Clayton Act. But it currently is prevented by statute from reviewing mergers of telecommunications common carriers. The FTC can and does, however, review mergers that do not involve companies regulated under Title II of the Communications Act. Given the blurring of lines between common carriage and packet-switched networks, the FTC may well take an increased role in telecommunications mergers in the future, particularly if it wins statutory authority to review Title II mergers.

In addition to its merger role, the FTC is the federal government's primary agent to protect consumers from fraud and other illegal practices perpetrated over the Internet. It testifies before Congress and may prepare federal cases concerning such crimes as theft of credit card information over the Internet, "identity theft" to purchase telecommunications services in a victim's name, or scams over the Internet that induce victims to send money for defective or non-existent goods or services.

4.2.2.3 The Commerce Department

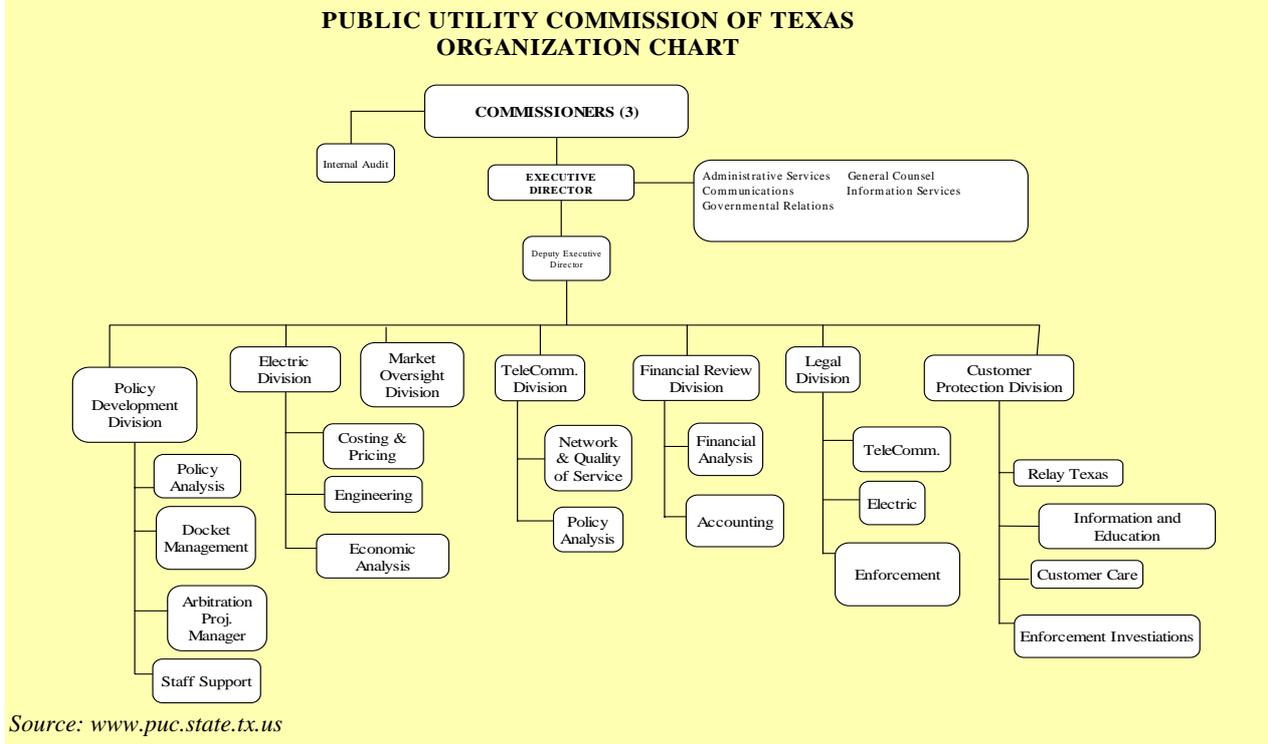
The National Telecommunications and Information Administration (NTIA), located within the Commerce Department, is the chief telecommunications policy advisory agency within the Executive Branch. It may conduct research, solicit industry comments and issue reports and recommendations on federal policy issues involving competition, universal service and broadband deployment. It also has an international branch that advises the rest of the Executive Branch and works with the International Bureau of the FCC to coordinate international service policy.

One of the primary roles of NTIA is to manage the radio spectrum designated for primary use by the federal government. NTIA is, therefore, the spectrum regulator for such critical operations as national defense, air traffic control, border and customs operations and the space program. Through a technical board known as the Interdepartment Radio Advisory Committee (IRAC), NTIA coordinates all of these federal spectrum uses.

4.2.2.4 The Securities and Exchange Commission

The SEC, an independent agency, sets and enforces rules regarding the public trading of securities and requiring public disclosure of corporate financial documents and records. The SEC is therefore intimately involved in monitoring the corporate governance of all publicly traded corporations in the United States, a category that includes most large communications companies. While the FCC has the authority to audit regulated companies' books with regard to rules implementing the Communications Act provisions (e.g., cost allocations, jurisdictional separations and affiliate transactions) the SEC oversees compliance with more general laws governing corporate activity and accounting, and their disclosure. The SEC has civil enforcement authority only; unlike the FCC it can only act through filing civil actions in U.S. courts.

Figure 3.8: Public Utility Commission of Texas - Organization Chart



4.2.2.5 Projecting U.S. Policies Abroad

The role of developing and representing U.S. telecom competition policies abroad is divided among numerous agencies and departments, under the aegis of the State Department, which maintains a Communications and Information Policy desk. The State Department organizes and leads official U.S. delegations to ITU conferences and conducts bilateral and multilateral negotiations with counterparts in other countries' foreign ministries. In practice, however, the State Department's staff works closely with the staffs of the FCC's International Bureau, NTIA and other agencies in the Commerce Department and other departments such as Defense or Transportation, drawing upon their expertise where necessary to frame and represent U.S. government positions.

Meanwhile, the Office of the U.S. Trade Representative (USTR) represents the country before the World Trade Organization and in other activities involving U.S. trade relations. In that role, USTR must often defend U.S. competition policy or explain it in disputes involving the policies of trading partners. USTR is a focal point for complaints and lobbying by U.S. carriers that encounter trade barriers or difficulties in foreign markets.

4.2.3 State Regulatory Commissions

Pursuant to their jurisdiction over intrastate services, the states maintain boards, commissions or departments within their governments to regulate the activities of utilities and regulated industries. In terms of organization, these bodies generally have appointed or elected commissioners, backed by a professional staff of lawyers and engineers. These public utility commissions, however, are generally not sector-specific. Having their origins in the early part of the last century, they were created to regulate all industries that were considered public utilities—a category that included telephone companies. Today, then, state public utility commissions generally regulate not only telecommunications but also electric and gas power utilities, water companies, and transportation industries, in some cases.⁷³

State commissions are responsible for licensing carriers that wish to offer service in that state. So in addition to obtaining federal approval from the FCC, a carrier wishing to enter domestic U.S. telecommunications markets will need to get state approval through processes (varying in each state) that may range from mere notification of the state agency to the filing of an application for a “certificate of public convenience and necessity.” In addition, carriers must then comply with all sector-specific laws and regulations enforced by each state commission, as well as the general business laws of each state. Add to that the variation in state taxation schemes, and you have a hodge-podge of state requirements that can far exceed the federal compliance burden.

The dispersal of power and authority does not stop even there, however. Officials of cities and counties have authority through local ordinances and franchise requirements. Wireless carriers commonly must obtain permission from local governments to build transmission towers.⁷⁴ Cable TV providers must often obtain local franchises. And facilities-based competitive telephone companies often face municipal obstacles in obtaining permission to dig up streets to access undercut conduits for cable installation.

5 The Application of Competition Policy Concepts

We will now turn to an examination of how competition policy concepts are applied in the context of antitrust law enforcement and sector-specific telecommunications regulation. We will utilize a comparative approach, first describing the competition policy precepts that are common or similar in both antitrust and regulatory practices, then focusing on how they have been applied by the FCC and the Justice Department (and in some cases, the FTC). In both cases, we will analyze how successful the market intervention strategies of these players have been. Finally, we will examine the interplay and balance between antitrust and sector-specific regulation and how that balance has changed over the years or may be in flux today.

5.1 Competition Policy Concepts

Certain elements of competition policy are identical or similar in analyses carried out by both the Justice Department and the FCC. These include:

- Defining markets in product and geographic terms;
- Analyzing markets to determine the extent of concentration;
- Analyzing markets to determine whether any single entity or group of entities does or can exercise market power;
- Examining ease of entry and exit; and
- Identifying whether any market participant controls essential facilities that are required by competitors as inputs to their own offerings.

While both sector-specific regulation and general competition policy utilize similar analytical tools as starting points, there are, however, significant distinctions in how they are applied. Perhaps the greatest distinctions lie in:

- The purposes for which the analyses of market power are carried out;
- The overall standard of review utilized; and
- The degree to which specific remedies and requirements are spelled out in statutes.

As we will explore in the following sections, the FCC generally carries out market analyses in one of two contexts: as part of a proceeding to alter sector-specific, *ex-ante* regulations, or as part of its review of license transfers required to complete mergers. Antitrust authorities, meanwhile, conduct analyses either as part of investigations to seek *ex-post* enforcement of antitrust laws or through Clayton Act pre-merger reviews.

Box 5.1: The FCC's Public Interest Standard

In its order approving the 1998 merger of MCI Communications Corp. and WorldCom, Inc., the FCC outlined the differences between its public interest standard and DoJ's antitrust standard:

The FCC examines not only the potential effect of the merger on competition, but also the balance of other potential benefits and harms to the public.

While the FCC's analysis of competitive effects is "informed" by antitrust principles, it is not "governed" by them.

The Commission must implement and enforce the Telecommunications Act of 1996, in which Congress established a "clear national policy that competition leading to deregulation, rather than continued regulation of dominant firms" should be paramount.⁷⁵

The FCC acknowledged that its competitive analysis was derived not only from its own *Competitive Carrier* and nondominance proceedings but also from the 1992 *Horizontal Merger Guidelines* employed by DoJ and the FTC. In approving the merger, the Commission defined the affected markets as (1) domestic long distance services, (2) U.S. international services, (3) Internet backbone services, and (4) Local exchange and exchange access services.

The Commission found no potential impairment of competition in the long distance or international service markets. It also accepted commitments from executives of both companies that they would seek to enter additional local service markets, thereby actually increasing competition. During the concurrent DoJ and FCC reviews, however, it became apparent that one or both of those agencies were concerned about Internet infrastructure concentration, particularly in the backbone market. To head off this problem, the merger partners agreed to divest MCI's Internet assets to Cable & Wireless plc. After that, the merger was allowed to proceed.

Even in the seemingly similar act of authorizing mergers, there are important differences in the standards the FCC and the Justice Department ("DoJ") or FTC apply. DoJ employs a narrow standard focusing purely on competition—whether or not the proposed business combination will violate the Sherman or Clayton Acts. The FCC, however, employs a much broader—and in the end somewhat less defined—"public interest" standard.

Finally, there is a distinction between the nature of statutes governing the FCC's actions and those governing antitrust enforcement. The Communications Act—particularly with its Telecom Act amendments—contains more specific, direct mandates and instructions, many of which, when implemented by the FCC, embody proactive, *ex-ante* requirements. The antitrust laws, on the other hand, are by necessity more general, and they apply punishment for proscribed behavior *after* it has occurred.

5.2 Sector-Specific Regulation

Sector-specific regulation in the United States incorporates competition policy as a fundamental precept. Policies developed and implemented by the FCC in the early 1980s began applying differing regulatory treatment to carriers based upon determinations of those carriers' ability to exercise market power or their control over "bottleneck" local exchange facilities. Moreover, as discussed in Section 4, the Telecommunications Act contained statutory provisions expressly enshrining the idea that it is necessary to apply more stringent network access requirements on incumbent carriers than on new market entrants. We will now discuss the evolution of these policies.

5.2.1 Defining and Analyzing Markets

A few years before the MFJ, the FCC had already begun to distinguish among carriers in newly contested markets, based on their ability to use market power to harm or forestall competition. In 1979, the FCC initiated its *Competitive Carrier Proceeding* to explore how it should regulate new firms entering the market to compete against AT&T's long distance service. In that proceeding, the Commission created two classifications of carriers: "dominant" carriers and "nondominant" carriers. The former were held to possess market power while the latter did not.⁷⁶ As the Commission stated, the ability of a carrier to abuse market power would allow it to violate the "just and reasonable rate" mandate and other provisions of the Communications Act:

“We proposed to distinguish between carriers on the basis of their dominance or power in the marketplace and apply different regulatory rules to each. A carrier would be labeled dominant if it has substantial opportunity and incentive to subsidize the rates for its more competitive services with revenues obtained from its monopoly or near-monopoly services. We recognized that the power to keep prices above full costs not only meant the firm could violate the “just and reasonable rate” mandate of the Act, but also that it could inefficiently invest in new or additional facilities and still produce enough revenue to recoup these wasteful costs.”⁷⁷

In a subsequent order, it defined market power as “the ability to raise prices by restricting output” and as “the ability to raise and maintain prices above the competitive level without driving away so many customers as to make the increase unprofitable.”⁷⁸ From this point onward, the Commission repeatedly engaged in market analyses to re-calibrate its rules and regulations to changing market conditions.

In full song, the FCC’s market analyses have defined the relevant product and geographic markets and encompassed a full assessment of market power. For example, in a 1995 order reclassifying AT&T as a non-dominant carrier for domestic interstate services (it had been regulated as dominant since Divestiture), the FCC defined a “single, national, . . . geographic market” for “all interstate, domestic, interexchange services.”⁷⁹ To determine whether AT&T continued to have market power in that market, the Commission then proceeded to analyze:

- (1) AT&T’s market share;
- (2) The supply elasticity of the market;
- (3) The demand elasticity of the market; and
- (4) AT&T’s cost structure, size and resources.⁸⁰

The FCC found that although AT&T may “still be able to control the price of a few discrete services,” it “neither possesses nor can exercise individual market power within” the defined market as a whole.⁸¹ In determining whether a company had market power, the FCC confirmed its approach, developed in the *Competitive Carrier Proceeding*, of looking at “the number and size distribution of competing firms, the nature of barriers to entry, and the availability of reasonably substitutable services,” as well as whether the firm controlled “bottleneck facilities.”⁸² Present in the FCC’s analysis, therefore, are key competition policy precepts of market power, market concentration, ease of entry and exit, and access to essential facilities.

The FCC continues today to employ the process outlined in the *Competitive Carrier Proceeding* and refined in the *AT&T Non-Dominance Order* and other proceedings.⁸³ For example, in its pending proceeding on regulatory treatment of incumbent LEC broadband services, the FCC currently is exploring a definition of the relevant product and geographic market and is seeking comments on whether the incumbents exercise market power within that market. The resulting analysis will be used to determine the “appropriate” regulatory requirements for the relevant services offered by the incumbents.⁸⁴

It should be noted, however, that unlike antitrust actions, the FCC’s competition analyses are always undertaken within the larger context of what end result would be in the overall public interest. Any decision to implement or maintain more stringent rules, for example, would not only take into account a competitive analysis but other factors as well, such as any regulatory costs to carriers that might be passed on to consumers or how regulation would effect network deployment. These factors would not necessarily be part of a classic antitrust analysis, which would focus solely on competition.

5.2.2 Asymmetric Regulation

The FCC’s asymmetrical approach to regulation was expressed by the early 1980s, in the form of dominant carrier regulation and the competitive safeguards imposed on incumbent LECs and AT&T through the *Computer Inquiries*. The Telecom Act perpetuated and even augmented the asymmetric regulatory regime

by adding statutory provisions that, as applied by the FCC, imposed further requirements upon certain carriers and not upon others.

5.2.2.1 FCC Dominant Carrier Regulation

At this juncture, no carrier is regulated as dominant in the domestic U.S. long distance market.⁸⁵ The Bell operating companies ("BOCs") and other incumbent local exchange carriers ("ILECs") continue to be regulated as dominant in local exchange service markets, based on market analyses and the ILECs' ongoing control over many local bottleneck facilities.

As dominant carriers, ILECs are subject to price cap regulation or, in the case of smaller ILECs, ongoing rate-of-return regulation. ILECs must continue to file federal tariffs stating their prices and terms of service for interstate services (in addition to intrastate tariffs filed with state regulatory commissions), including the access services that allow long distance carriers to originate and terminate interstate calls on ILEC local networks. Tariffs must be accompanied by cost-support data in most cases and must be publicly filed with a notice period before they take effect, allowing anyone potentially affected by them to challenge the proposed terms. In addition, significant data reporting requirements are imposed on ILECs. Competitive LECs ("CLECs"), which are primarily new market entrants, are subject to less comprehensive requirements. This regulatory disparity is based on the judgment that CLECs, as nondominant carriers, do not have market power and thus cannot harm or hinder competition.

The FCC's classification of carriers—and the resulting asymmetric regulation—is not static, however. The Commission has established a glide path for substantial deregulation of dominant carriers, culminating in reclassification as nondominant, as markets grow more competitive. In its *Interstate Interexchange Competition* proceeding, begun in 1990, the FCC found that for certain services, the long distance market had become "substantially competitive."⁸⁶ For those particular services, the FCC decided to "streamline" regulation of AT&T, withdrawing price cap regulation (in effect ending all price regulation), drastically shortening tariff notice requirements and ending cost-support obligations for tariffing new services. And as already noted, this led, eventually, to AT&T's successful petition for reclassification as nondominant in 1995.

The FCC has not reclassified ILECs as nondominant, although it is considering, in a pending proceeding, a petition by SBC Communications, Inc., for reclassification of ILEC broadband services. The Commission could also streamline regulation of those services, as an interim step, without fully reclassifying them as nondominant. Further, the FCC has already given ILECs some "pricing flexibility" in its price cap regulation, in geographic areas where competition thresholds have been met.⁸⁷

5.2.2.2 Statutory Asymmetry

As noted in Section 4, the Telecom Act imposed certain market-opening obligations on certain classes of LECs and not upon others. There is, in effect, a cascade of regulatory obligations imposed on various classes of carrier:

- All carriers— interconnection;
- All LECs — resale, number portability, dialing parity, access to rights-of-way and reciprocal compensation for terminating calls;
- All incumbent LECs — duty to negotiate interconnection in good faith, interconnection at any feasible point, unbundled access to UNEs priced at cost, offering of services for resale at a mandated wholesale discount, and collocation;
- BOCs — prohibition of certain interLATA services, a 14-point checklist to win interLATA relief, a structural separation requirement once such relief is won.

The Act itself cites no specific basis in competition policy for this statutory asymmetry; however, it is clear from the legislative history that in the case of unbundling and interconnection mandates, the law was designed to curb the ability of carriers to abuse local exchange market power.⁸⁸ To be sure, competition was not the sole aim of Congress in enacting the law, but in specifically targeting ILECs and BOCs for certain

provisions, Congress was inherently applying an asymmetrical approach, based on competition policy precepts of market power and control of essential facilities.

5.2.3 FCC License Transfers

Under the Clayton Act, the FCC has a measure of concurrent authority to review proposed mergers between common carriers.⁸⁹ Indeed, the Commission may, in theory, wish to undertake such a review where, for example, the monetary threshold of a merger does not reach the Hart-Scott-Rodino threshold for pre-reporting to the Justice Department or the FTC.

In practice, however, the Commission's reviews are not antitrust reviews. Rather, in strict terms, they are proceedings under the Communications Act to transfer wireless licenses and facilities authorizations from existing companies to the newly merged entity. The distinction between FCC license transfer proceedings and antitrust reviews carried out under the Clayton Act is crucial and fundamental. Whereas concern about the impact on competition is the sole focus of antitrust reviews, the FCC applies its much broader "public interest" standard under the Communications Act. This involves considering a whole host of factors—including, among other things, consumer welfare, service quality, broadband deployment or the promotion of facilities-based networks—to determine whether, on balance, a merger would benefit the public.

Of course, one of the public interest factors (and a prominent one) is whether the proposed combination would foster or hinder competition, thereby affecting consumers either positively or negatively. To resolve this question, the FCC carries out a market analysis based upon whatever information it can collect through public comments and submissions by the parties. The analysis proceeds along the lines employed for dominant carrier analysis: definition of markets, examination of participants and likely entrants, and a determination of how the merger would enhance concentration or allow the merged company to exercise market power.

The Commission often attaches conditions to its approval of license transfers, which may or may not address the same or similar concerns addressed by the Justice Department in a consent decree. For example, in approving a horizontal merger between the two Bell companies Ameritech and SBC, the Commission insisted upon the merged company's agreement to a plan that, among other things, required the merged company to enter a specified number of local service markets outside the Ameritech and SBC region.

The FCC's practice in the 1990s of attaching far-reaching merger conditions left the agency open to criticism (including from some of its own commissioners) that the Commission was engaging in "rulemaking by merger approval."⁹⁰ Knowing that companies would accede to its wishes in order to secure merger approval, the Commission appeared to be seeking to drive home its policy objectives by coercion. These critics urged the FCC to confine its merger reviews to the bare minimum required to determine whether the combinations would be in the public interest—without creating new policy in the bargain. Defenders of "active" merger reviews argued, however, that the imposition of conditions counterbalanced real concerns about anti-competitive effects, achieving a net positive result that allowed the merger to go forward at all.

Box 5.2: Conditioning a Bell Consolidation Move

In the case of SBC Communications, Inc.'s proposed merger with (or, in practice, purchase of) Ameritech Corp., the FCC found significant potential threats to competition. The Commission decided the merger would:

Eliminate a potential source of local service competition in both merger partners' home regions and elsewhere throughout the country;

Eliminate an independent source of "comparative practices analysis" among the dwindling numbers of Bell regional holding companies; and

Increase the ability and motivation of the merged company to discriminate against rivals, particularly in the advanced service market.⁹¹

These potential drawbacks, the FCC noted, were not totally counterbalanced by potential public interest benefits of the proposed merger. The parties sought to improve their chances for approval, however, by submitting a list of some 75 detailed concessions that the FCC later incorporated as conditions in its order. The conditions were designed to promote advanced service deployment; ensure the opening of local service markets; foster out-of-territory competition among BOCs; and improve residential service.

The FCC thus borrows heavily from core competition policy principles in its application of asymmetric regulation, its implementation of the Telecom Act provisions governing network access to facilitate market entry, and its review of proposed mergers. The promotion of competition, however, is just one goal the FCC must balance along with others, pursuant to the Communications Act, when it regulates in the public interest.

5.3 Antitrust Enforcement

5.3.1 Department of Justice (DoJ) as a 'Regulator'?

Historically, the Justice Department has had a prominent role in determining the structure of the U.S. telecommunications market—perhaps as prominent as that of the FCC. As far back as the 1913 Kingsbury Commitment, the threat of antitrust action has hovered over the industry—particularly when AT&T dominated the market through the Bell System. The Justice Department made good on that threat in the MFJ, which was instrumental in contributing to the development of long distance service competition. Although by the 1980s the FCC was also working to allow competition in long distance and customer premises equipment markets, it had only the most vague statutory mandate (the public interest) to do so. Prior to 1996, the Communications Act did not mandate competition. The Bell System had, in fact, existed for some 50 years as a regulated monopoly under the Act.

From 1984 until the enactment of the Telecom Act, Judge Harold Greene of the U.S. District Court in Washington, D.C., adjudicated compliance with the Consent Decree. As a party to the original antitrust case, the Justice Department continued to participate in proceedings before Judge Greene, filing responses whenever a Bell company sought a waiver from the court to offer any proscribed interLATA service.

Is it possible, though, to say that the Justice Department was ever a "regulator" of competition in the U.S. telecommunications market? Certainly, the remedies imposed through the Consent Decree from 1984 onward altered the structure of the market profoundly. Without a doubt, Justice intervened in the market in a crucial, and largely successful, manner, at least with regard to the stated aim of preventing monopoly leveraging of essential facilities into the long distance market. But at no point did either DoJ or Judge Greene engage in the kind of detailed economic regulation (for example, price regulation or cost allocations) practiced by the FCC or the state commissions. In a sense, DoJ cut out the pieces of the fabric, while the regulators stitched them together.

The Justice Department's primary role, then and now, is to be a "watchdog" to ensure the protection and enhancement of competitive markets. It is not, however, a "sheepdog" that constantly herds regulated entities toward policy goals. It is more of a monitor than a regulator, intervening only reactively when it senses market functions are broken, not proactively to achieve pre-stated government aims.

DoJ continues to have authority, under the “antitrust savings clause” of the Telecommunications Act and the antitrust laws themselves, to press civil antitrust claims in U.S. courts.⁹² In order to establish a monopolization violation claim under Section 2 of the Sherman Act, DoJ or any other claimant must show “(1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power, as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.”⁹³

A firm that does not achieve monopoly power may violate Section 2 anyway, through “attempted monopolization,” which is proved by a showing of (1) anticompetitive or exclusionary conduct, (2) with specific intent to monopolize, and (3) a dangerous probability of achieving monopoly power.”⁹⁴ In practical terms, the Telecommunications Act has muddied the waters concerning the Justice Department’s ability to act proactively in civil claims alleging antitrust violations. This is because the federal courts have been somewhat divided over the issue of whether the more specific statutory competition mandates in the Telecom Act superseded the more general antitrust laws in many circumstances (See Box 5.3).

Box 5.3: When Competition Policy Frameworks Overlap

Since the enactment of the Telecommunications Act of 1996, the federal courts have had to sort out the sector-specific Act’s relationship to general antitrust law. As the Seventh Circuit U.S. appeals court termed it, “The question that confronts us here is how and where these two competition-friendly regimes intersect.”⁹⁵ The Seventh Circuit posed this question in the case of *Richard Goldwasser, et al., v. Ameritech Corp.*, a class action lawsuit in which the plaintiffs argued that Ameritech, a Bell company, had violated both the Telecom Act and the Sherman Act. Of 20 specific allegations, 17 cited specific provisions of the Telecom Act. Affirming the lower court, the appeals court held that the plaintiffs had failed to allege any antitrust claim independent of the Telecom Act violations and that the “more specific legislation” must “take precedence over the general antitrust laws, where the two are covering precisely the same field.”⁹⁶

This appeared to give the Telecom Act’s sector-specific framework precedence whenever it overlapped with claims under the more general antitrust laws. Subsequent cases, however, further clouded the picture. In *Law Offices of Curtis V. Trinko, L.L.P. v. Bell Atlantic Corp.*, a lower court had ruled that the class action plaintiffs’ antitrust claims were invalid because they would interfere with the interconnection negotiation process set forth in the Telecom Act.⁹⁷ The lower court cited *Goldwasser* in its ruling.

But the Second Circuit overturned the lower court in June 2002, ruling that antitrust claims were not universally preempted by allegations of Telecom Act violations. The Second Circuit noted that certain antitrust claims—for example, those stemming from the essential facilities doctrine or monopoly leveraging behavior—could be pursued independently of the Telecom Act’s provisions. Moreover, the court noted that the plaintiffs, who were end users, had no redress for a violation of Telecom Act Section 251, which applied only to the interconnection rights of carriers.⁹⁸ That left the Sherman Act as the plaintiffs’ only tool to obtain redress for the alleged violations of competition law. The Second Circuit concluded that unless there was a “plain repugnancy”—a clear clash between the intent of a sector-specific statute and an antitrust law—“we will not assume that a regulatory statute implicitly repeals the antitrust laws.”⁹⁹

This holding received support in August 2002 from a third appeals court, the Eleventh Circuit, which held in *Covad Communications Co., et al. v. BellSouth Corp.* that “a Sherman Act claim could be brought based on allegations of anti-competitive conduct that was ‘intertwined’ with obligations established by the Telecommunications Act of 1996.”¹⁰⁰ The Eleventh Circuit found that rather than preempting the Sherman Act, it was Congress’ intent that the Telecom Act be used “in tandem” with existing antitrust laws to stimulate competition. The courts appeared, with their rulings in 2002, to be correcting the signal sent in *Goldwasser* that the Telecom Act precluded the making of separate antitrust claims covering the same violations. The *Covad* and *Law Offices* rulings appeared likely to restore a balance between sector-specific and general competition regimes.

5.3.2 Antitrust Merger Reviews

5.3.2.1 *The Horizontal Merger Guidelines*

When the Justice Department reviews horizontal mergers of telecommunications carriers, it follows an expressly stated process, spelled out in a set of published guidelines. The current set of guidelines was published in 1992, with revisions in 1997. The FTC follows the same guidelines when it reviews noncommon-carrier mergers. The goal of the guidelines is to describe "the analytical foundations of merger enforcement and [provide] guidance enabling the business community to avoid antitrust problems when planning mergers."¹⁰¹ (See Annex I)

The guidelines focus on "the one potential source of gain that is of concern under the antitrust laws: market power."¹⁰² The guidelines emphasize that a merger is not likely to enhance or create market power unless the net effect would be to increase *concentration* within that market. "Mergers that either do not significantly increase concentration or do not result in a concentrated market ordinarily require no further analysis," the guidelines state.¹⁰³ Pursuant to the guidelines, the Department (or the FTC) follow these steps:

1. Defining the market — Markets are defined both in terms of products and geographically, using demand substitution analysis. That is, a market is the smallest group of products, or geographic area, in which a hypothetical profit-maximizing monopolist could implement a "small but significant and non-transitory" price increase without forcing sufficient numbers of customers to choose an alternative, making the price increase unprofitable.¹⁰⁴ The Department will keep adding products, or enlarging the geographic area, until it finds that no further substitution is possible.
2. Identifying market participants — The Department begins by identifying all the companies that sell or produce the products in the defined market. It also will include companies that are likely to enter the market as alternative suppliers if there is a small but significant price increase by the existing participants. Companies that can quickly enter or exit the defined market, without significant sunk costs, are termed "uncommitted entrants."¹⁰⁵
3. Determining market concentration — Market shares are calculated based on revenues, sales, shipments or whatever measurement best captures a firm's "future competitive significance."¹⁰⁶ Market shares are then analyzed through the Herfindahl-Hirschman Index (HHI), which provides a yardstick of market concentration (See Box 5.4). This allows the Department to gauge the impact any proposed merger would have upon concentration by calculating the post-merger HHI in advance.

Box 5.4: The HHI: A Gauge of Market Concentration

The Herfindahl-Hirschman Index (HHI) for any market is the sum of the squares of all the companies' market shares. If the HHI of a market is less than 1,000, the market is considered "unconcentrated." If the HHI is between 1,000 and 1,800, the market is held to be "moderately" concentrated. Any HHI above 1,800 is thought to denote a highly concentrated market.

For example, if a single firm had a market share of 80%, and its two competitors divided the remaining 20% evenly, the resulting HHI would be 6600--well in excess of the threshold for determining high concentration. If, on the other hand, 10 firms evenly split the market, the resulting HHI would be 1,000, posing little concern to the Department. In merger reviews, the Department calculates a post-merger HHI to see whether the combination would increase market concentration. It does so in the following manner:

Market HHIs below 1,000. If the proposed merger would result in an HHI below 1,000, the Department would perceive the market as still unconcentrated and likely would not analyze the merger further.

Market HHIs between 1,000 and 1,800. Where the post-merger HHI would be between 1,000 and 1,800, any merger that increased concentration by less than 100 HHI points would still be considered as having minimal impact and would not be analyzed further. Any merger that increased the overall HHI by more than 100 points would cause concern and lead to further analysis.

Market HHIs above 1,800. Similarly, in highly concentrated markets (those above 1,800 HHI) any merger that would increase the already high HHI by 50 points or more would lead to further merger review. Any merger with an impact of less than 50 points on concentration would not raise significant anti-competitive concerns.

4. Determining the likelihood of coordination — The Department looks at whether an increase in market concentration will increase the likelihood that firms will coordinate their actions in a way that will minimize competition. If market conditions make such coordination more likely, the merger may contribute to the ability of one or more firms to exert market power and punish any deviations from coordinated action (even actual collusion) in the market.¹⁰⁷
5. Conducting a market entry analysis — A merger is less likely to enhance market power if market entry is sufficiently easy that any significant price increase would simply attract a flood of new competitors, making the price increase unsustainable. In network-based communications markets, however, market entry is often more likely to be the product of a long-term business plan involving substantial sunk costs in terms of network plant.
6. Analyzing internal efficiencies — DoJ or the FTC will analyze whether, despite anticompetitive concerns, a merger may have the potential to generate significant internal efficiencies that would allow the merged firm to lower its costs. This would positively affect the merged company's ability to compete against remaining firms in the market, spurring positive competitive effects, such as lower prices.¹⁰⁸ Only "cognizable efficiencies"—those narrowly attributed to the merger—are to be taken into account, not those that may "arise from anticompetitive reductions in output or service."¹⁰⁹
7. Consideration of imminent failure — Finally, DoJ and the FTC will take into consideration the potential imminent failure of one of the merging companies. Mergers usually do not create or enhance market power if they are effected to prevent one or more of the merging firms from failing and taking its assets out of the market entirely.¹¹⁰

These guidelines are designed to provide the industry with a clear picture—or perhaps notice—of what uncharted waters they may be preparing to embark upon when they enter into merger negotiations. The consideration of vertical mergers follows a similar pattern, with the addition of analyses of other elements, such as essential facilities, that could be used to discriminate against competitors in downstream or adjacent markets.

Unlike FCC license transfer proceedings, DoJ and FTC merger reviews take place outside the public's view. If the Department (or the FTC) believes a proposed merger will have negative effects, it may negotiate a Consent Decree including remedies. If an agreement cannot be reached with the merger partners, it will file a judicial complaint to block the merger or force the implementation of remedies.

Box 5.5 The FTC's Review of the AOL-Time Warner Merger

Because the planned merger of America Online (AOL) and Time Warner did not involve a telecommunications common carrier, it could be reviewed by the Federal Trade Commission (FTC) rather than the Justice Department. On December 14, 2000, the FTC announced a "consent order" had been negotiated with the merger partners to remedy potential violations of Section 7 of the Clayton Act, as well as the Federal Trade Commission Act.¹¹¹ The FTC had determined that the proposed merger of the media giants would lessen competition in the residential broadband Internet access market, undermine AOL's incentive to promote the DSL Internet access service it had developed as an alternative to cable modem service and would restrain competition in the budding interactive television market.

Under the terms of the consent order, AOL Time Warner agreed to:

Make available to subscribers at least one non-affiliated cable broadband ISP service on Time Warner's cable modem platform *before* AOL began offering ISP service (as well as providing access to two additional non-affiliated ISPs within 90 days after AOL was made available on Time Warner's cable systems);

Not interfere with any content passed along the bandwidth provided by Time Warner to non-affiliated ISPs, or discriminate among ISPs based on affiliation, including with regard to the transmission of "interactive triggers" or other interactive TV content; and

Make available AOL's DSL service to subscribers in Time Warner's cable modem service areas, at terms and the same retail pricing available in areas where Time Warner cable modem service was not available.

With the parties' agreement to the consent order—and pending implementation of the agreed remedies, the FTC made no further effort to block the merger.

5.3.2.2 International Cooperation

In recent years, several mergers, such as the proposed merger of British Telecommunications plc and MCI, have involved markets that were defined as global in scope. This has led the Justice Department into increasingly close coordination with competition authorities outside the United States (particularly with the European Commission). In some cases, DoJ and its partners may not be able to share certain proprietary information submitted by proposed merger partners. The Department can, however, share its views and concerns about proposed combinations in order to avoid conflicting decisions on merger analyses and remedies. Clear channels of communication with other antitrust officials help DoJ avoid a situation in which a company may secure more lenient treatment in one jurisdiction, then use that to pressure another jurisdiction to follow suit.

5.4 The Balance between Antitrust and Regulation

Despite their commonalities and parallel development, sector-specific regulation and antitrust continue to occupy different terrain in the U.S. legal system. As stated in *Law Offices of Curtis V. Trinko*, the courts recognize that plaintiffs may state antitrust claims—based, for example, on the essential facilities doctrine or a monopoly leveraging claim—apart from allegations of specific violations of the Communications Act.¹¹² (Merely in pecuniary terms, plaintiffs may wish to pursue antitrust claims because they call for a trebling of damage awards rather than simply an administrative penalty that may be imposed by the FCC for a violation of the Act or its rules.) And as already stated, sector-specific regulation is much more broadly focused than antitrust enforcement.

Both sector-specific regulation and antitrust enforcement are designed to coexist. Still, there is little doubt that the Justice Department is less active in overseeing telecommunications industries than it was under the 1982 AT&T Consent Decree. Since 1996, Justice has, in a sense, “returned to the barracks”—as Congress perhaps envisioned that it would. The Telecom Act put regulatory authority squarely in the hands of the FCC and the state commissions and gave them both an increased mandate and tools to promote competition. As reflected in the *Goldwasser* judgment, the Justice Department’s activity in cases involving telecommunications markets has, in practice, lessened accordingly.

Legislation has been introduced in Congress that would reverse the pendulum and mandate greater Justice Department involvement, once again, in supervising telecommunications. One bill (H.R. 1697), for example, would give the Department the power to block interLATA relief if it believed a Bell operating company retained market power in the local service market in the relevant state. Another bill, H.R. 1698, would effectively reverse the *Goldwasser* ruling by making any violation of Sections 251-252 and 271-272, *ipso facto* a violation of antitrust laws. Yet another bill (H.R. 2120) incorporates similar provisions to give DoJ power over interLATA market entry and to protect plaintiffs’ ability to file antitrust claims without preemption by the Communications Act.

The battle to reassert the power of the Justice Department eerily echoes a similar debate prior to passage of the Telecom Act. At that time, long distance carriers, with allies among Democratic legislators, tried unsuccessfully to make the Justice Department the agency that would approve BOC interLATA applications—not the FCC. In the end, they won only the requirement that the FCC (whose role was championed by ILECs and many Republicans) must consult with the Department before rendering its decision. At writing, it appeared that the current crop of bills would be similarly unsuccessful in transferring more “regulatory” authority to the Justice Department. In the waning days of the 107th Congress, none of the bills had been reported out of committee. Their likely demise in 2002 would entail having to reintroduce them in a new Congress in 2003.

What then is the role of the Justice Department, and antitrust enforcement in general, in 2002? The answer is, the same role as in the years prior to the MFJ. In the U.S. system of checks and balances, DoJ is the ultimate “backstop” for competition. If market failures produce anti-competitive results, it can be expected to act again (if its political leadership is willing) to intervene where regulation has fallen short.

6 Conclusion

6.1 How Effective Are Antitrust and Sector-Specific Policies?

As related in this case study, the combination of FCC policies and the MFJ in the early 1980s were notably successful in creating conditions for the growth of competition in CPE and long distance markets. This era provides perhaps the best example of how antitrust market intervention and the Commission's determination of the public interest can coincide in complementary policies. This points to the conclusion that competition policies function best when they are employed in tandem.

Yet the market reforms of the early 1980s were to some extent, the "low-hanging" fruit of competition. Relatively high prices paid by consumers for long distance services presented a clear "arbitrage" opportunity for competitors to enter the long distance market. Consumers rapidly embraced the free market for telephone handsets. Yet much more entrenched advantages remained for incumbent local exchange carriers in their monopoly markets.

Congress employed a sector-specific approach in the Telecom Act of 1996 to extend competition into the more infrastructure-intensive local service markets. Implementation of the Telecom Act has produced steady, incremental growth in competition, but the results have not matched expectations of the boom decade just past. ILECs continue to hold market shares of up to 90 percent. Most American homeowners have no real alternative supplier of traditional, landline telephony and only two choices of broadband Internet access platforms. The CLEC industry currently is burdened by debt and haunted by bankruptcy. If the sector-specific approach of the Telecom Act has not failed, it has not, at present, not succeeded well enough to satisfy all expectations.

In the midst of an industry downturn, some second-guessing is inevitable. Few critics have questioned the efficacy of the Telecom Act itself. But in the constant policy ferment that is Washington, some have questioned the FCC's decisions in implementing the Act, while others have taken another approach, insisting that the ILECs themselves have done everything they could to resist the market-opening mandates of the Act.

Perhaps expectedly, the ILECs have generally espoused the first theory. In some proceedings, they have argued that the FCC, under previous Democratically controlled Commissions, erred in implementing the Telecommunications Act by imposing overly "regulatory" requirements, including an unnecessarily intrusive unbundling regime. Bolstered by a recent appeals court decision overturning and remanding the Commission's unbundling and line sharing rules,¹¹³ the ILECs are now lobbying the FCC to shorten the list of UNEs, at least enough to invalidate UNE-P as a market-entry strategy. The ILECs argue that a too-extensive unbundling mandate has actually undercut competition by discouraging competitors from engaging in sound investments in their own facilities. Moreover, they argue that continuing to apply unbundling requirements to ILEC broadband networks will destroy ILECs' incentives to aggressively deploy broadband capabilities.

In the same proceedings,¹¹⁴ meanwhile, long distance carriers, CLECs and ISPs are pressing to head off any erosion of unbundling requirements or deregulation of ILEC broadband networks and services. The competitors see the relatively slow development of competition (as well as the fortunes of their industries) as a direct result of foot-dragging by the ILECs. Watering down network access policies, they argue, would only further entrench the BOCs, which are now rapidly becoming reunified "full service" carriers through successful interLATA petitions.

The FCC, under Republican Michael Powell, has sought to recast competition as being inclusive of different network platforms. The telephony market in any given area may not have to contain 50 competitive phone companies. It could consist of one or two phone companies, six mobile service providers, a cable TV company and, eventually, multiple ISPs providing VoIP service. This has brought increased focus on setting the stage for viable intermodal competition through stepped up broadband deployment and the cultivation of alternative platforms such as fixed wireless. More than in the past, the Commission is also sensitive to calls for deregulating the industry and would prefer to create regulatory parity through streamlining or forbearance

than through imposing new or existing regulatory regimes on previously unaffected industry segments (e.g., ISPs).

At writing, the stage was set for FCC decisions on unbundling and broadband deregulation. A revision of the UNE list and/or partial deregulation (through streamlining or reclassification) of ILEC broadband services—as appeared possible—could well frustrate CLECs and long distance carriers, who see their market positions as increasingly threatened by ILECs. They are likely to use every legal arrow in their quivers, including judicial appeals and antitrust claims where possible, to continue battling the ILECs.

6.2 The Costs and Benefits of Complexity

Few policy frameworks in the world can match the U.S. competition policy apparatus for complexity. Few have as many different players, in terms of individuals or agencies, pursuing implementation or enforcement of as many different laws, on as many different jurisdictional levels. This stems partly from the organic evolution of competition policy, in both antitrust and sector-specific incarnations, over the past century. And in part, this complexity is simply an outgrowth of the almost rococo system of checks and balances that permeates the U.S. governmental system as a whole. No single actor or agency can determine, unilaterally, what U.S. competition policy will be. The costs of this complexity manifest themselves in several ways:

- The propensity (or need) to resort to litigation and appeals to achieve policy goals;
- A creeping incrementalism that breeds “satisficing” decisions that “split the baby” among industry groups but leave many hard choices to be made another day;
- A crushing and perplexing regulatory compliance burden that falls upon both domestic U.S. market participants and foreign market entrants alike;
- An inherent tension in relations between state and federal regulators and, at times, between regulators and antitrust authorities; and
- A lack of coordination or overall policy direction on competition that would serve to guide the entire industry and policy community.

U.S. officials interviewed for this case study were universal in stating that the U.S. competition policy model should not, and probably could not, be lifted wholesale for use as a model by other governments, particularly in smaller, developing countries. Just one facet of the U.S. system—the jurisdictional division of authority between the federal government and the states—renders it useless for application in most other circumstances. The U.S. experience does, however, offer benefits and lessons that can and should be adapted by other governments to their own situations:

- Adherence to the rule of law — Because of the built-in checks and balances, judicial review, and opportunities for public comment and appeal, U.S. policy is inevitably an expression of law, not the opinions or interests of individual personalities within the government.
- Perpetual re-examination — The ability of individuals to file antitrust lawsuits, or of companies to petition the FCC, assures that competition policy is in a constant state of flux. Even if change may occur only incrementally, it occurs constantly.
- Multiplication of talents — With increases in inter-agency communication and task forces, instant communication within and between governments can result in a productive pooling of resources and talents, multiplying the “brain power” that can be brought to bear upon analysis and decision-making.
- Effective enforcement — The ability of courts to mandate remedies, monitored by the Justice Department, makes antitrust action a sharp and heavy instrument. The FCC, meanwhile, has called for legislation to increase the size of fines it can levy.
- Well-reasoned decision-making — FCC decisions must be supported by the public record and explained in detail in Commission orders. DoJ and FTC complaints and arguments ultimately must pass muster in the courts. This prevents arbitrary and unprofessional judgments that discriminate against a single company or industry segment.

6.3 Challenges and Areas for Further Study

The U.S. dual system of sector-specific regulation and antitrust law enforcement, while enormously complex, has been moderately successful in accommodating and promoting competition. Moreover, it is being constantly adjusted and modified to maximize results. Keeping in mind that there are hundreds of policy professionals that spend much of their time seeking to improve the implementation of competition policy in the U.S., we here identify several ongoing challenges and suggestions for further study:

1. Avoiding overlap and duplication — Given the complexity of the U.S. policy process, officials must constantly avoid duplicating tasks that can be accomplished as well or better by other agencies.
2. Minimizing jurisdictional conflicts — The jurisdictional division between state and federal authorities can at times be unwieldy, and officials at federal, state and local levels are constantly trying to minimize conflict and maximize cooperation.
3. Regionalizing state policies and processes — The patchwork of different state requirements, from licensing to merger reviews, can pose a compliance burden for foreign and domestic carriers alike. States are responding by developing regional approaches wherever possible, such as for interLATA market entry proceedings. Study should be given to whether regional or national model forms and applications should be developed and whether states should appoint ombudsmen to help companies navigate through each state's regulatory processes.
4. Drafting an overall competition blueprint — It is not always clear whose role it is to conceptualize and articulate overall competition policy, beyond what is contained in static legislation. A possibility, for further study, may be for the FCC to periodically (perhaps every presidential term) publish a competition policy statement, with input from Congress, NTIA and state regulators.
5. Setting clear policy goals and checking progress — Perhaps as part of the blueprint process, clear goals for the development of competition in various markets could be set and supported by empirical market research and economic forecasting. Progress toward these goals could be periodically reviewed and the goals could be revised, retired or abandoned. Potential remedies—including deregulation, antitrust action or congressional legislation—could be proposed to facilitate further progress.
6. Comparative studies — Further studies of competition policy regimes in other parts of the world could be conducted, potentially by the FCC's Office of Plans and Policy or NTIA's international staff, to monitor the effectiveness of other approaches. Particular attention should be given to other regimes that balance sector-specific regulation and antitrust enforcement, as well as to regimes that use one approach or the other exclusively.
7. Historical research — Further studies could be conducted regarding market conditions during the first competitive era of U.S. telephony (circa 1893-1915). The purpose would be to define whether more rigorous antitrust enforcement or regulatory policies favoring full competition, rather than regulated monopoly, could have been instrumental in stemming the Bell System's market power. What pro-competitive policies were tried, if any, and how effective were they? Are there areas where rapid deregulation is called for?
8. Cross-sectoral studies — More study may be needed to survey the relationships and balance between general antitrust regulation and sector-specific regulation of other industries, such as electric power or airline transportation. State regulatory agencies, which are multi-sectoral, may serve as useful models or points of reference.

Annex I: Horizontal Merger Guidelines

U.S. Department of Justice and the Federal Trade Commission

1992 HORIZONTAL MERGER GUIDELINES

[WITH APRIL 8, 1997, REVISIONS TO SECTION 4 ON EFFICIENCIES]

The U.S. Department of Justice ("Department") and Federal Trade Commission ("Commission") today jointly issued Horizontal Merger Guidelines revising the Department's 1984 Merger Guidelines and the Commission's 1982 Statement Concerning Horizontal Merger Guidelines. The release marks the first time that the two federal agencies that share antitrust enforcement jurisdiction have issued joint guidelines.

Central to the 1992 Department of Justice and Federal Trade Commission Horizontal Merger Guidelines is a recognition that sound merger enforcement is an essential component of our free enterprise system benefitting the competitiveness of American firms and the welfare of American consumers. Sound merger enforcement must prevent anticompetitive mergers yet avoid deterring the larger universe of procompetitive or competitively neutral mergers. The 1992 Horizontal Merger Guidelines implement this objective by describing the analytical foundations of merger enforcement and providing guidance enabling the business community to avoid antitrust problems when planning mergers. The Department first released Merger Guidelines in 1968 in order to inform the business community of the analysis applied by the Department to mergers under the federal antitrust laws. The 1968 Merger Guidelines eventually fell into disuse, both internally and externally, as they were eclipsed by developments in legal and economic thinking about mergers.

In 1982, the Department released revised Merger Guidelines which, reflecting those developments, departed dramatically from the 1968 version. Relative to the Department's actual practice, however, the 1982 Merger Guidelines represented an evolutionary not revolutionary change. On the same date, the Commission released its Statement Concerning Horizontal Mergers highlighting the principal considerations guiding the Commission's horizontal merger enforcement and noting the "considerable weight" given by the Commission to the Department's 1982 Merger Guidelines.

The Department's current Merger Guidelines, released in 1984, refined and clarified the analytical framework of the 1982 Merger Guidelines. Although the agencies' experience with the 1982 Merger Guidelines reaffirmed the soundness of its underlying principles, the Department concluded that there remained room for improvement.

The revisions embodied in the 1992 Horizontal Merger Guidelines reflect the next logical step in the development of the agencies' analysis of mergers. They reflect the Department's experience in applying the 1982 and 1984 Merger Guidelines as well as the Commission's experience in applying those guidelines and the Commission's 1982 Statement. Both the Department and the Commission believed that their respective Guidelines and Statement presented sound frameworks for antitrust analysis of mergers, but that improvements could be made to reflect advances in legal and economic thinking. The 1992 Horizontal Merger Guidelines accomplish this objective and also clarify certain aspects of the Merger Guidelines that proved to be ambiguous or were interpreted by observers in ways that were inconsistent with the actual policy of the agencies.

The 1992 Horizontal Merger Guidelines do not include a discussion of horizontal effects from non-horizontal mergers (e.g., elimination of specific potential entrants and competitive problems from vertical mergers). Neither agency has changed its policy with respect to non-horizontal mergers. Specific guidance on non-horizontal mergers is provided in Section 4 of the Department's 1984 Merger Guidelines, read in the context of today's revisions to the treatment of horizontal mergers.

A number of today's revisions are largely technical or stylistic. One major objective of the revisions is to strengthen the document as an analytical road map for the evaluation of mergers. The language, therefore, is

intended to be burden-neutral, without altering the burdens of proof or burdens of coming forward as those standards have been established by the courts. In addition, the revisions principally address two areas.

The most significant revision to the Merger Guidelines is to explain more clearly how mergers may lead to adverse competitive effects and how particular market factors relate to the analysis of those effects. These revisions are found in Section 2 of the Horizontal Merger Guidelines. The second principal revision is to sharpen the distinction between the treatment of various types of supply responses and to articulate the framework for analyzing the timeliness, likelihood and sufficiency of entry. These revisions are found in Sections 1.3 and 3.

The new Horizontal Merger Guidelines observe, as did the 1984 Guidelines, that because the specific standards they set out must be applied in widely varied factual circumstances, mechanical application of those standards could produce misleading results. Thus, the Guidelines state that the agencies will apply those standards reasonably and flexibly to the particular facts and circumstances of each proposed merger.

0. PURPOSE, UNDERLYING POLICY ASSUMPTIONS AND OVERVIEW

These Guidelines outline the present enforcement policy of the Department of Justice and the Federal Trade Commission (the "Agency") concerning horizontal acquisitions and mergers ("mergers") subject to section 7 of the Clayton Act,(1)

to section 1 of the Sherman Act,(2)

or to section 5 of the FTC Act.(3) They describe the analytical framework and specific standards normally used by the Agency in analyzing mergers.(4) By stating its policy as simply and clearly as possible, the Agency hopes to reduce the uncertainty associated with enforcement of the antitrust laws in this area.

Although the Guidelines should improve the predictability of the Agency's merger enforcement policy, it is not possible to remove the exercise of judgment from the evaluation of mergers under the antitrust laws. Because the specific standards set forth in the Guidelines must be applied to a broad range of possible factual circumstances, mechanical application of those standards may provide misleading answers to the economic questions raised under the antitrust laws. Moreover, information is often incomplete and the picture of competitive conditions that develops from historical evidence may provide an incomplete answer to the forward-looking inquiry of the Guidelines. Therefore, the Agency will apply the standards of the Guidelines reasonably and flexibly to the particular facts and circumstances of each proposed merger.

0.1 Purpose and Underlying Policy Assumptions of the Guidelines

The Guidelines are designed primarily to articulate the analytical framework the Agency applies in determining whether a merger is likely substantially to lessen competition, not to describe how the Agency will conduct the litigation of cases that it decides to bring. Although relevant in the latter context, the factors contemplated in the Guidelines neither dictate nor exhaust the range of evidence that the Agency must or may introduce in litigation. Consistent with their objective, the Guidelines do not attempt to assign the burden of proof, or the burden of coming forward with evidence, on any particular issue. Nor do the Guidelines attempt to adjust or reapportion burdens of proof or burdens of coming forward as those standards have been established by the courts.(5) Instead, the Guidelines set forth a methodology for analyzing issues once the necessary facts are available. The necessary facts may be derived from the documents and statements of both the merging firms and other sources.

Throughout the Guidelines, the analysis is focused on whether consumers or producers "likely would" take certain actions, that is, whether the action is in the actor's economic interest. References to the profitability of certain actions focus on economic profits rather than accounting profits. Economic profits may be defined as the excess of revenues over costs where costs include the opportunity cost of invested capital.

Mergers are motivated by the prospect of financial gains. The possible sources of the financial gains from mergers are many, and the Guidelines do not attempt to identify all possible sources of gain in every merger. Instead, the Guidelines focus on the one potential source of gain that is of concern under the antitrust laws: market power.

The unifying theme of the Guidelines is that mergers should not be permitted to create or enhance market power or to facilitate its exercise. Market power to a seller is the ability profitably to maintain prices above competitive levels for a significant period of time.(6) In some circumstances, a sole seller (a "monopolist") of

a product with no good substitutes can maintain a selling price that is above the level that would prevail if the market were competitive. Similarly, in some circumstances, where only a few firms account for most of the sales of a product, those firms can exercise market power, perhaps even approximating the performance of a monopolist, by either explicitly or implicitly coordinating their actions. Circumstances also may permit a single firm, not a monopolist, to exercise market power through unilateral or non-coordinated conduct--conduct the success of which does not rely on the concurrence of other firms in the market or on coordinated responses by those firms. In any case, the result of the exercise of market power is a transfer of wealth from buyers to sellers or a misallocation of resources.

Market power also encompasses the ability of a single buyer (a "monopsonist"), a coordinating group of buyers, or a single buyer, not a monopsonist, to depress the price paid for a product to a level that is below the competitive price and thereby depress output. The exercise of market power by buyers ("monopsony power") has adverse effects comparable to those associated with the exercise of market power by sellers. In order to assess potential monopsony concerns, the Agency will apply an analytical framework analogous to the framework of these Guidelines.

While challenging competitively harmful mergers, the Agency seeks to avoid unnecessary interference with the larger universe of mergers that are either competitively beneficial or neutral. In implementing this objective, however, the Guidelines reflect the congressional intent that merger enforcement should interdict competitive problems in their incipiency.

0.2 Overview

The Guidelines describe the analytical process that the Agency will employ in determining whether to challenge a horizontal merger. First, the Agency assesses whether the merger would significantly increase concentration and result in a concentrated market, properly defined and measured. Second, the Agency assesses whether the merger, in light of market concentration and other factors that characterize the market, raises concern about potential adverse competitive effects. Third, the Agency assesses whether entry would be timely, likely and sufficient either to deter or to counteract the competitive effects of concern. Fourth, the Agency assesses any efficiency gains that reasonably cannot be achieved by the parties through other means. Finally the Agency assesses whether, but for the merger, either party to the transaction would be likely to fail, causing its assets to exit the market. The process of assessing market concentration, potential adverse competitive effects, entry, efficiency and failure is a tool that allows the Agency to answer the ultimate inquiry in merger analysis: whether the merger is likely to create or enhance market power or to facilitate its exercise.

1. MARKET DEFINITION, MEASUREMENT AND CONCENTRATION

1.0 Overview

A merger is unlikely to create or enhance market power or to facilitate its exercise unless it significantly increases concentration and results in a concentrated market, properly defined and measured. Mergers that either do not significantly increase concentration or do not result in a concentrated market ordinarily require no further analysis.

The analytic process described in this section ensures that the Agency evaluates the likely competitive impact of a merger within the context of economically meaningful markets--i.e., markets that could be subject to the exercise of market power. Accordingly, for each product or service (hereafter "product") of each merging firm, the Agency seeks to define a market in which firms could effectively exercise market power if they were able to coordinate their actions.

Market definition focuses solely on demand substitution factors--i.e., possible consumer responses. Supply substitution factors--i.e., possible production responses--are considered elsewhere in the Guidelines in the identification of firms that participate in the relevant market and the analysis of entry. See Sections 1.3 and 3. A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a "small but significant and nontransitory" increase in price, assuming the terms of sale of all other products are held constant. A relevant market is a group of products and a geographic area that is no bigger than necessary to satisfy this test. The "small but significant and non-transitory" increase in price is employed solely as a methodological tool for the analysis of mergers: it is not a tolerance level for price increases.

Absent price discrimination, a relevant market is described by a product or group of products and a geographic area. In determining whether a hypothetical monopolist would be in a position to exercise market power, it is necessary to evaluate the likely demand responses of consumers to a price increase. A price increase could be made unprofitable by consumers either switching to other products or switching to the same product produced by firms at other locations. The nature and magnitude of these two types of demand responses respectively determine the scope of the product market and the geographic market.

In contrast, where a hypothetical monopolist likely would discriminate in prices charged to different groups of buyers, distinguished, for example, by their uses or locations, the Agency may delineate different relevant markets corresponding to each such buyer group. Competition for sales to each such group may be affected differently by a particular merger and markets are delineated by evaluating the demand response of each such buyer group. A relevant market of this kind is described by a collection of products for sale to a given group of buyers.

Once defined, a relevant market must be measured in terms of its participants and concentration. Participants include firms currently producing or selling the market's products in the market's geographic area. In addition, participants may include other firms depending on their likely supply responses to a "small but significant and nontransitory" price increase. A firm is viewed as a participant if, in response to a "small but significant and nontransitory" price increase, it likely would enter rapidly into production or sale of a market product in the market's area, without incurring significant sunk costs of entry and exit. Firms likely to make any of these supply responses are considered to be "uncommitted" entrants because their supply response would create new production or sale in the relevant market and because that production or sale could be quickly terminated without significant loss.(7)

Uncommitted entrants are capable of making such quick and uncommitted supply responses that they likely influenced the market premerger, would influence it post-merger, and accordingly are considered as market participants at both times. This analysis of market definition and market measurement applies equally to foreign and domestic firms.

If the process of market definition and market measurement identifies one or more relevant markets in which the merging firms are both participants, then the merger is considered to be horizontal. Sections 1.1 through 1.5 describe in greater detail how product and geographic markets will be defined, how market shares will be calculated and how market concentration will be assessed.

1.1 Product Market Definition

The Agency will first define the relevant product market with respect to each of the products of each of the merging firms.(8)

1.11 General Standards

Absent price discrimination, the Agency will delineate the product market to be a product or group of products such that a hypothetical profit-maximizing firm that was the only present and future seller of those products ("monopolist") likely would impose at least a "small but significant and nontransitory" increase in price. That is, assuming that buyers likely would respond to an increase in price for a tentatively identified product group only by shifting to other products, what would happen? If the alternatives were, in the aggregate, sufficiently attractive at their existing terms of sale, an attempt to raise prices would result in a reduction of sales large enough that the price increase would not prove profitable, and the tentatively identified product group would prove to be too narrow.

Specifically, the Agency will begin with each product (narrowly defined) produced or sold by each merging firm and ask what would happen if a hypothetical monopolist of that product imposed at least a "small but significant and nontransitory" increase in price, but the terms of sale of all other products remained constant. If, in response to the price increase, the reduction in sales of the product would be large enough that a hypothetical monopolist would not find it profitable to impose such an increase in price, then the Agency will add to the product group the product that is the next-best substitute for the merging firm's product.(9)

In considering the likely reaction of buyers to a price increase, the Agency will take into account all relevant evidence, including, but not limited to, the following:

(1) evidence that buyers have shifted or have considered shifting purchases between products in response to relative changes in price or other competitive variables;

- (2) evidence that sellers base business decisions on the prospect of buyer substitution between products in response to relative changes in price or other competitive variables;
- (3) the influence of downstream competition faced by buyers in their output markets; and
- (4) the timing and costs of switching products.

The price increase question is then asked for a hypothetical monopolist controlling the expanded product group. In performing successive iterations of the price increase test, the hypothetical monopolist will be assumed to pursue maximum profits in deciding whether to raise the prices of any or all of the additional products under its control. This process will continue until a group of products is identified such that a hypothetical monopolist over that group of products would profitably impose at least a "small but significant and nontransitory" increase, including the price of a product of one of the merging firms. The Agency generally will consider the relevant product market to be the smallest group of products that satisfies this test.

In the above analysis, the Agency will use prevailing prices of the products of the merging firms and possible substitutes for such products, unless premerger circumstances are strongly suggestive of coordinated interaction, in which case the Agency will use a price more reflective of the competitive price.⁽¹⁰⁾

However, the Agency may use likely future prices, absent the merger, when changes in the prevailing prices can be predicted with reasonable reliability. Changes in price may be predicted on the basis of, for example, changes in regulation which affect price either directly or indirectly by affecting costs or demand.

In general, the price for which an increase will be postulated will be whatever is considered to be the price of the product at the stage of the industry being examined.⁽¹¹⁾ In attempting to determine objectively the effect of a "small but significant and nontransitory" increase in price, the Agency, in most contexts, will use a price increase of five percent lasting for the foreseeable future. However, what constitutes a "small but significant and nontransitory" increase in price will depend on the nature of the industry, and the Agency at times may use a price increase that is larger or smaller than five percent.

1.12 Product Market Definition in the Presence of Price Discrimination

The analysis of product market definition to this point has assumed that price discrimination--charging different buyers different prices for the same product, for example--would not be profitable for a hypothetical monopolist. A different analysis applies where price discrimination would be profitable for a hypothetical monopolist.

Existing buyers sometimes will differ significantly in their likelihood of switching to other products in response to a "small but significant and nontransitory" price increase. If a hypothetical monopolist can identify and price differently to those buyers ("targeted buyers") who would not defeat the targeted price increase by substituting to other products in response to a "small but significant and nontransitory" price increase for the relevant product, and if other buyers likely would not purchase the relevant product and resell to targeted buyers, then a hypothetical monopolist would profitably impose a discriminatory price increase on sales to targeted buyers. This is true regardless of whether a general increase in price would cause such significant substitution that the price increase would not be profitable. The Agency will consider additional relevant product markets consisting of a particular use or uses by groups of buyers of the product for which a hypothetical monopolist would profitably and separately impose at least a "small but significant and nontransitory" increase in price.

1.2 Geographic Market Definition

For each product market in which both merging firms participate, the Agency will determine the geographic market or markets in which the firms produce or sell. A single firm may operate in a number of different geographic markets.

1.21 General Standards

Absent price discrimination, the Agency will delineate the geographic market to be a region such that a hypothetical monopolist that was the only present or future producer of the relevant product at locations in that region would profitably impose at least a "small but significant and nontransitory" increase in price,

holding constant the terms of sale for all products produced elsewhere. That is, assuming that buyers likely would respond to a price increase on products produced within the tentatively identified region only by shifting to products produced at locations of production outside the region, what would happen? If those locations of production outside the region were, in the aggregate, sufficiently attractive at their existing terms of sale, an attempt to raise price would result in a reduction in sales large enough that the price increase would not prove profitable, and the tentatively identified geographic area would prove to be too narrow.

In defining the geographic market or markets affected by a merger, the Agency will begin with the location of each merging firm (or each plant of a multiplant firm) and ask what would happen if a hypothetical monopolist of the relevant product at that point imposed at least a "small but significant and nontransitory" increase in price, but the terms of sale at all other locations remained constant. If, in response to the price increase, the reduction in sales of the product at that location would be large enough that a hypothetical monopolist producing or selling the relevant product at the merging firm's location would not find it profitable to impose such an increase in price, then the Agency will add the location from which production is the next-best substitute for production at the merging firm's location.

In considering the likely reaction of buyers to a price increase, the Agency will take into account all relevant evidence, including, but not limited to, the following:

- (1) evidence that buyers have shifted or have considered shifting purchases between different geographic locations in response to relative changes in price or other competitive variables;
- (2) evidence that sellers base business decisions on the prospect of buyer substitution between geographic locations in response to relative changes in price or other competitive variables;
- (3) the influence of downstream competition faced by buyers in their output markets; and
- (4) the timing and costs of switching suppliers.

The price increase question is then asked for a hypothetical monopolist controlling the expanded group of locations. In performing successive iterations of the price increase test, the hypothetical monopolist will be assumed to pursue maximum profits in deciding whether to raise the price at any or all of the additional locations under its control. This process will continue until a group of locations is identified such that a hypothetical monopolist over that group of locations would profitably impose at least a "small but significant and nontransitory" increase, including the price charged at a location of one of the merging firms.

The "smallest market" principle will be applied as it is in product market definition. The price for which an increase will be postulated, what constitutes a "small but significant and nontransitory" increase in price, and the substitution decisions of consumers all will be determined in the same way in which they are determined in product market definition.

1.22 Geographic Market Definition in the Presence of Price Discrimination

The analysis of geographic market definition to this point has assumed that geographic price discrimination--charging different prices net of transportation costs for the same product to buyers in different areas, for example--would not be profitable for a hypothetical monopolist. However, if a hypothetical monopolist can identify and price differently to buyers in certain areas ("targeted buyers") who would not defeat the targeted price increase by substituting to more distant sellers in response to a "small but significant and nontransitory" price increase for the relevant product, and if other buyers likely would not purchase the relevant product and resell to targeted buyers,(12)

then a hypothetical monopolist would profitably impose a discriminatory price increase. This is true even where a general price increase would cause such significant substitution that the price increase would not be profitable. The Agency will consider additional geographic markets consisting of particular locations of buyers for which a hypothetical monopolist would profitably and separately impose at least a "small but significant and nontransitory" increase in price.

1.3 Identification of Firms that Participate in the Relevant Market

1.31 Current Producers or Sellers

The Agency's identification of firms that participate in the relevant market begins with all firms that currently produce or sell in the relevant market. This includes vertically integrated firms to the extent that

such inclusion accurately reflects their competitive significance in the relevant market prior to the merger. To the extent that the analysis under Section 1.1 indicates that used, reconditioned or recycled goods are included in the relevant market, market participants will include firms that produce or sell such goods and that likely would offer those goods in competition with other relevant products.

1.32 Firms That Participate Through Supply Response

In addition, the Agency will identify other firms not currently producing or selling the relevant product in the relevant area as participating in the relevant market if their inclusion would more accurately reflect probable supply responses. These firms are termed "uncommitted entrants." These supply responses must be likely to occur within one year and without the expenditure of significant sunk costs of entry and exit, in response to a "small but significant and nontransitory" price increase. If a firm has the technological capability to achieve such an uncommitted supply response, but likely would not (e.g., because difficulties in achieving product acceptance, distribution, or production would render such a response unprofitable), that firm will not be considered to be a market participant. The competitive significance of supply responses that require more time or that require firms to incur significant sunk costs of entry and exit will be considered in entry analysis. See Section 3.(13)

Sunk costs are the acquisition costs of tangible and intangible assets that cannot be recovered through the redeployment of these assets outside the relevant market, i.e., costs uniquely incurred to supply the relevant product and geographic market. Examples of sunk costs may include market-specific investments in production facilities, technologies, marketing (including product acceptance), research and development, regulatory approvals, and testing. A significant sunk cost is one which would not be recouped within one year of the commencement of the supply response, assuming a "small but significant and nontransitory" price increase in the relevant market. In this context, a "small but significant and nontransitory" price increase will be determined in the same way in which it is determined in product market definition, except the price increase will be assumed to last one year. In some instances, it may be difficult to calculate sunk costs with precision. Accordingly, when necessary, the Agency will make an overall assessment of the extent of sunk costs for firms likely to participate through supply responses.

These supply responses may give rise to new production of products in the relevant product market or new sources of supply in the relevant geographic market. Alternatively, where price discrimination is likely so that the relevant market is defined in terms of a targeted group of buyers, these supply responses serve to identify new sellers to the targeted buyers. Uncommitted supply responses may occur in several different ways: by the switching or extension of existing assets to production or sale in the relevant market; or by the construction or acquisition of assets that enable production or sale in the relevant market.

1.321 Production Substitution and Extension: The Switching or Extension of Existing Assets to Production or Sale in the Relevant Market

The productive and distributive assets of a firm sometimes can be used to produce and sell either the relevant products or products that buyers do not regard as good substitutes. Production substitution refers to the shift by a firm in the use of assets from producing and selling one product to producing and selling another. Production extension refers to the use of those assets, for example, existing brand names and reputation, both for their current production and for production of the relevant product. Depending upon the speed of that shift and the extent of sunk costs incurred in the shift or extension, the potential for production substitution or extension may necessitate treating as market participants firms that do not currently produce the relevant product.(14)

If a firm has existing assets that likely would be shifted or extended into production and sale of the relevant product within one year, and without incurring significant sunk costs of entry and exit, in response to a "small but significant and nontransitory" increase in price for only the relevant product, the Agency will treat that firm as a market participant. In assessing whether a firm is such a market participant, the Agency will take into account the costs of substitution or extension relative to the profitability of sales at the elevated price, and whether the firm's capacity is elsewhere committed or elsewhere so profitably employed that such capacity likely would not be available to respond to an increase in price in the market.

1.322 Obtaining New Assets for Production or Sale of the Relevant Product

A firm may also be able to enter into production or sale in the relevant market within one year and without the expenditure of significant sunk costs of entry and exit, in response to a "small but significant and

nontransitory" increase in price for only the relevant product, even if the firm is newly organized or is an existing firm without products or productive assets closely related to the relevant market. If new firms, or existing firms without closely related products or productive assets, likely would enter into production or sale in the relevant market within one year without the expenditure of significant sunk costs of entry and exit, the Agency will treat those firms as market participants.

1.4 Calculating Market Shares

1.41 General Approach

The Agency normally will calculate market shares for all firms (or plants) identified as market participants in Section 1.3 based on the total sales or capacity currently devoted to the relevant market together with that which likely would be devoted to the relevant market in response to a "small but significant and nontransitory" price increase. Market shares can be expressed either in dollar terms through measurement of sales, shipments, or production, or in physical terms through measurement of sales, shipments, production, capacity, or reserves.

Market shares will be calculated using the best indicator of firms' future competitive significance. Dollar sales or shipments generally will be used if firms are distinguished primarily by differentiation of their products. Unit sales generally will be used if firms are distinguished primarily on the basis of their relative advantages in serving different buyers or groups of buyers. Physical capacity or reserves generally will be used if it is these measures that most effectively distinguish firms.⁽¹⁵⁾ Typically, annual data are used, but where individual sales are large and infrequent so that annual data may be unrepresentative, the Agency may measure market shares over a longer period of time.

In measuring a firm's market share, the Agency will not include its sales or capacity to the extent that the firm's capacity is committed or so profitably employed outside the relevant market that it would not be available to respond to an increase in price in the market.

1.42 Price Discrimination Markets

When markets are defined on the basis of price discrimination (Sections 1.12 and 1.22), the Agency will include only sales likely to be made into, or capacity likely to be used to supply, the relevant market in response to a "small but significant and nontransitory" price increase.

1.43 Special Factors Affecting Foreign Firms

Market shares will be assigned to foreign competitors in the same way in which they are assigned to domestic competitors. However, if exchange rates fluctuate significantly, so that comparable dollar calculations on an annual basis may be unrepresentative, the Agency may measure market shares over a period longer than one year.

If shipments from a particular country to the United States are subject to a quota, the market shares assigned to firms in that country will not exceed the amount of shipments by such firms allowed under the quota.⁽¹⁶⁾

In the case of restraints that limit imports to some percentage of the total amount of the product sold in the United States (i.e., percentage quotas), a domestic price increase that reduced domestic consumption also would reduce the volume of imports into the United States. Accordingly, actual import sales and capacity data will be reduced for purposes of calculating market shares. Finally, a single market share may be assigned to a country or group of countries if firms in that country or group of countries act in coordination.

1.5 Concentration and Market Shares

Market concentration is a function of the number of firms in a market and their respective market shares. As an aid to the interpretation of market data, the Agency will use the Herfindahl-Hirschman Index ("HHI") of market concentration. The HHI is calculated by summing the squares of the individual market shares of all the participants.⁽¹⁷⁾ Unlike the four-firm concentration ratio, the HHI reflects both the distribution of the market shares of the top four firms and the composition of the market outside the top four firms. It also gives proportionately greater weight to the market shares of the larger firms, in accord with their relative importance in competitive interactions.

The Agency divides the spectrum of market concentration as measured by the HHI into three regions that can be broadly characterized as unconcentrated (HHI below 1000), moderately concentrated (HHI between 1000

and 1800), and highly concentrated (HHI above 1800). Although the resulting regions provide a useful framework for merger analysis, the numerical divisions suggest greater precision than is possible with the available economic tools and information. Other things being equal, cases falling just above and just below a threshold present comparable competitive issues.

1.51 General Standards

In evaluating horizontal mergers, the Agency will consider both the post-merger market concentration and the increase in concentration resulting from the merger.⁽¹⁸⁾

Market concentration is a useful indicator of the likely potential competitive effect of a merger. The general standards for horizontal mergers are as follows:

a) Post-Merger HHI Below 1000. The Agency regards markets in this region to be unconcentrated. Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis.

b) Post-Merger HHI Between 1000 and 1800. The Agency regards markets in this region to be moderately concentrated. Mergers producing an increase in the HHI of less than 100 points in moderately concentrated markets post-merger are unlikely to have adverse competitive consequences and ordinarily require no further analysis. Mergers producing an increase in the HHI of more than 100 points in moderately concentrated markets post-merger potentially raise significant competitive concerns depending on the factors set forth in Sections 2-5 of the Guidelines.

c) Post-Merger HHI Above 1800. The Agency regards markets in this region to be highly concentrated. Mergers producing an increase in the HHI of less than 50 points, even in highly concentrated markets post-merger, are unlikely to have adverse competitive consequences and ordinarily require no further analysis. Mergers producing an increase in the HHI of more than 50 points in highly concentrated markets post-merger potentially raise significant competitive concerns, depending on the factors set forth in Sections 2-5 of the Guidelines. Where the post-merger HHI exceeds 1800, it will be presumed that mergers producing an increase in the HHI of more than 100 points are likely to create or enhance market power or facilitate its exercise. The presumption may be overcome by a showing that factors set forth in Sections 2-5 of the Guidelines make it unlikely that the merger will create or enhance market power or facilitate its exercise, in light of market concentration and market shares.

1.52 Factors Affecting the Significance of Market Shares and Concentration

The post-merger level of market concentration and the change in concentration resulting from a merger affect the degree to which a merger raises competitive concerns. However, in some situations, market share and market concentration data may either understate or overstate the likely future competitive significance of a firm or firms in the market or the impact of a merger. The following are examples of such situations.

1.521 Changing Market Conditions

Market concentration and market share data of necessity are based on historical evidence. However, recent or ongoing changes in the market may indicate that the current market share of a particular firm either understates or overstates the firm's future competitive significance. For example, if a new technology that is important to long-term competitive viability is available to other firms in the market, but is not available to a particular firm, the Agency may conclude that the historical market share of that firm overstates its future competitive significance. The Agency will consider reasonably predictable effects of recent or ongoing changes in market conditions in interpreting market concentration and market share data.

1.522 Degree of Difference Between the Products and Locations in the Market and Substitutes Outside the Market

All else equal, the magnitude of potential competitive harm from a merger is greater if a hypothetical monopolist would raise price within the relevant market by substantially more than a "small but significant and nontransitory" amount. This may occur when the demand substitutes outside the relevant market, as a group, are not close substitutes for the products and locations within the relevant market. There thus may be a wide gap in the chain of demand substitutes at the edge of the product and geographic market. Under such circumstances, more market power is at stake in the relevant market than in a market in which a hypothetical monopolist would raise price by exactly five percent.

2. THE POTENTIAL ADVERSE COMPETITIVE EFFECTS OF MERGERS

2.0 Overview

Other things being equal, market concentration affects the likelihood that one firm, or a small group of firms, could successfully exercise market power. The smaller the percentage of total supply that a firm controls, the more severely it must restrict its own output in order to produce a given price increase, and the less likely it is that an output restriction will be profitable. If collective action is necessary for the exercise of market power, as the number of firms necessary to control a given percentage of total supply decreases, the difficulties and costs of reaching and enforcing an understanding with respect to the control of that supply might be reduced. However, market share and concentration data provide only the starting point for analyzing the competitive impact of a merger. Before determining whether to challenge a merger, the Agency also will assess the other market factors that pertain to competitive effects, as well as entry, efficiencies and failure.

This section considers some of the potential adverse competitive effects of mergers and the factors in addition to market concentration relevant to each. Because an individual merger may threaten to harm competition through more than one of these effects, mergers will be analyzed in terms of as many potential adverse competitive effects as are appropriate. Entry, efficiencies, and failure are treated in Sections 3-5.

2.1 Lessening of Competition Through Coordinated Interaction

A merger may diminish competition by enabling the firms selling in the relevant market more likely, more successfully, or more completely to engage in coordinated interaction that harms consumers. Coordinated interaction is comprised of actions by a group of firms that are profitable for each of them only as a result of the accommodating reactions of the others. This behavior includes tacit or express collusion, and may or may not be lawful in and of itself.

Successful coordinated interaction entails reaching terms of coordination that are profitable to the firms involved and an ability to detect and punish deviations that would undermine the coordinated interaction. Detection and punishment of deviations ensure that coordinating firms will find it more profitable to adhere to the terms of coordination than to pursue short-term profits from deviating, given the costs of reprisal. In this phase of the analysis, the Agency will examine the extent to which post-merger market conditions are conducive to reaching terms of coordination, detecting deviations from those terms, and punishing such deviations. Depending upon the circumstances, the following market factors, among others, may be relevant: the availability of key information concerning market conditions, transactions and individual competitors; the extent of firm and product heterogeneity; pricing or marketing practices typically employed by firms in the market; the characteristics of buyers and sellers; and the characteristics of typical transactions.

Certain market conditions that are conducive to reaching terms of coordination also may be conducive to detecting or punishing deviations from those terms. For example, the extent of information available to firms in the market, or the extent of homogeneity, may be relevant to both the ability to reach terms of coordination and to detect or punish deviations from those terms. The extent to which any specific market condition will be relevant to one or more of the conditions necessary to coordinated interaction will depend on the circumstances of the particular case.

It is likely that market conditions are conducive to coordinated interaction when the firms in the market previously have engaged in express collusion and when the salient characteristics of the market have not changed appreciably since the most recent such incident. Previous express collusion in another geographic market will have the same weight when the salient characteristics of that other market at the time of the collusion are comparable to those in the relevant market.

In analyzing the effect of a particular merger on coordinated interaction, the Agency is mindful of the difficulties of predicting likely future behavior based on the types of incomplete and sometimes contradictory information typically generated in merger investigations. Whether a merger is likely to diminish competition by enabling firms more likely, more successfully or more completely to engage in coordinated interaction depends on whether market conditions, on the whole, are conducive to reaching terms of coordination and detecting and punishing deviations from those terms.

2.11 Conditions Conducive to Reaching Terms of Coordination

Firms coordinating their interactions need not reach complex terms concerning the allocation of the market output across firms or the level of the market prices but may, instead, follow simple terms such as a common price, fixed price differentials, stable market shares, or customer or territorial restrictions. Terms of coordination need not perfectly achieve the monopoly outcome in order to be harmful to consumers. Instead, the terms of coordination may be imperfect and incomplete -- inasmuch as they omit some market participants, omit some dimensions of competition, omit some customers, yield elevated prices short of monopoly levels, or lapse into episodic price wars--and still result in significant competitive harm. At some point, however, imperfections cause the profitability of abiding by the terms of coordination to decrease and, depending on their extent, may make coordinated interaction unlikely in the first instance.

Market conditions may be conducive to or hinder reaching terms of coordination. For example, reaching terms of coordination may be facilitated by product or firm homogeneity and by existing practices among firms, practices not necessarily themselves antitrust violations, such as standardization of pricing or product variables on which firms could compete. Key information about rival firms and the market may also facilitate reaching terms of coordination. Conversely, reaching terms of coordination may be limited or impeded by product heterogeneity or by firms having substantially incomplete information about the conditions and prospects of their rival's businesses, perhaps because of important differences among their current business operations. In addition, reaching terms of coordination may be limited or impeded by firm heterogeneity, for example, differences in vertical integration or the production of another product that tends to be used together with the relevant product.

2.12 Conditions Conducive to Detecting and Punishing Deviations

Where market conditions are conducive to timely detection and punishment of significant deviations, a firm will find it more profitable to abide by the terms of coordination than to deviate from them. Deviation from the terms of coordination will be deterred where the threat of punishment is credible. Credible punishment, however, may not need to be any more complex than temporary abandonment of the terms of coordination by other firms in the market.

Where detection and punishment likely would be rapid, incentives to deviate are diminished and coordination is likely to be successful. The detection and punishment of deviations may be facilitated by existing practices among firms, themselves not necessarily antitrust violations, and by the characteristics of typical transactions. For example, if key information about specific transactions or individual price or output levels is available routinely to competitors, it may be difficult for a firm to deviate secretly. If orders for the relevant product are frequent, regular and small relative to the total output of a firm in a market, it may be difficult for the firm to deviate in a substantial way without the knowledge of rivals and without the opportunity for rivals to react. If demand or cost fluctuations are relatively infrequent and small, deviations may be relatively easy to deter.

By contrast, where detection or punishment is likely to be slow, incentives to deviate are enhanced and coordinated interaction is unlikely to be successful. If demand or cost fluctuations are relatively frequent and large, deviations may be relatively difficult to distinguish from these other sources of market price fluctuations, and, in consequence, deviations may be relatively difficult to deter.

In certain circumstances, buyer characteristics and the nature of the procurement process may affect the incentives to deviate from terms of coordination. Buyer size alone is not the determining characteristic. Where large buyers likely would engage in long-term contracting, so that the sales covered by such contracts can be large relative to the total output of a firm in the market, firms may have the incentive to deviate. However, this only can be accomplished where the duration, volume and profitability of the business covered by such contracts are sufficiently large as to make deviation more profitable in the long term than honoring the terms of coordination, and buyers likely would switch suppliers.

In some circumstances, coordinated interaction can be effectively prevented or limited by maverick firms--firms that have a greater economic incentive to deviate from the terms of coordination than do most of their rivals (e.g., firms that are unusually disruptive and competitive influences in the market). Consequently, acquisition of a maverick firm is one way in which a merger may make coordinated interaction more likely, more successful, or more complete. For example, in a market where capacity constraints are significant for many competitors, a firm is more likely to be a maverick the greater is its excess or divertable capacity in relation to its sales or its total capacity, and the lower are its direct and opportunity costs of expanding sales in the relevant market.(19)

This is so because a firm's incentive to deviate from price-elevating and output-limiting terms of coordination is greater the more the firm is able profitably to expand its output as a proportion of the sales it would obtain if it adhered to the terms of coordination and the smaller is the base of sales on which it enjoys elevated profits prior to the price cutting deviation.⁽²⁰⁾ A firm also may be a maverick if it has an unusual ability secretly to expand its sales in relation to the sales it would obtain if it adhered to the terms of coordination. This ability might arise from opportunities to expand captive production for a downstream affiliate.

2.2 Lessening of Competition Through Unilateral Effects

A merger may diminish competition even if it does not lead to increased likelihood of successful coordinated interaction, because merging firms may find it profitable to alter their behavior unilaterally following the acquisition by elevating price and suppressing output. Unilateral competitive effects can arise in a variety of different settings. In each setting, particular other factors describing the relevant market affect the likelihood of unilateral competitive effects. The settings differ by the primary characteristics that distinguish firms and shape the nature of their competition.

2.21 Firms Distinguished Primarily by Differentiated Products

In some markets the products are differentiated, so that products sold by different participants in the market are not perfect substitutes for one another. Moreover, different products in the market may vary in the degree of their substitutability for one another. In this setting, competition may be non-uniform (i.e., localized), so that individual sellers compete more directly with those rivals selling closer substitutes.⁽²¹⁾

A merger between firms in a market for differentiated products may diminish competition by enabling the merged firm to profit by unilaterally raising the price of one or both products above the premerger level. Some of the sales loss due to the price rise merely will be diverted to the product of the merger partner and, depending on relative margins, capturing such sales loss through merger may make the price increase profitable even though it would not have been profitable premerger. Substantial unilateral price elevation in a market for differentiated products requires that there be a significant share of sales in the market accounted for by consumers who regard the products of the merging firms as their first and second choices, and that repositioning of the non-parties' product lines to replace the localized competition lost through the merger be unlikely. The price rise will be greater the closer substitutes are the products of the merging firms, i.e., the more the buyers of one product consider the other product to be their next choice.

2.211 Closeness of the Products of the Merging Firms

The market concentration measures articulated in Section 1 may help assess the extent of the likely competitive effect from a unilateral price elevation by the merged firm notwithstanding the fact that the affected products are differentiated. The market concentration measures provide a measure of this effect if each product's market share is reflective of not only its relative appeal as a first choice to consumers of the merging firms' products but also its relative appeal as a second choice, and hence as a competitive constraint to the first choice⁽²²⁾ where this circumstance holds, market concentration data fall outside the safeharbor regions of Section 1.5, and the merging firms have a combined market share of at least thirty-five percent, the Agency will presume that a significant share of sales in the market are accounted for by consumers who regard the products of the merging firms as their first and second choices.

Purchasers of one of the merging firms, products may be more or less likely to make the other their second choice than market shares alone would indicate. The market shares of the merging firms, products may understate the competitive effect of concern, when, for example, the products of the merging firms are relatively more similar in their various attributes to one another than to other products in the relevant market. On the other hand, the market shares alone may overstate the competitive effects of concern when, for example, the relevant products are less similar in their attributes to one another than to other products in the relevant market.

Where market concentration data fall outside the safeharbor regions of Section 1.5, the merging firms have a combined market share of at least thirty-five percent, and where data on product attributes and relative product appeal show that a significant share of purchasers of one merging firm's product regard the other as their second choice, then market share data may be relied upon to demonstrate that there is a significant share of sales in the market accounted for by consumers who would be adversely affected by the merger.

2.212 Ability of Rival Sellers to Replace Lost Competition

A merger is not likely to lead to unilateral elevation of prices of differentiated products if, in response to such an effect, rival sellers likely would replace any localized competition lost through the merger by repositioning their product lines.(23)

In markets where it is costly for buyers to evaluate product quality, buyers who consider purchasing from both merging parties may limit the total number of sellers they consider. If either of the merging firms would be replaced in such buyers, consideration by an equally competitive seller not formerly considered, then the merger is not likely to lead to a unilateral elevation of prices.

2.22 Firms Distinguished Primarily by Their Capacities

Where products are relatively undifferentiated and capacity primarily distinguishes firms and shapes the nature of their competition, the merged firm may find it profitable unilaterally to raise price and suppress output. The merger provides the merged firm a larger base of sales on which to enjoy the resulting price rise and also eliminates a competitor to which customers otherwise would have diverted their sales. Where the merging firms have a combined market share of at least thirty-five percent, merged firms may find it profitable to raise price and reduce joint output below the sum of their premerger outputs because the lost markups on the foregone sales may be outweighed by the resulting price increase on the merged base of sales.

This unilateral effect is unlikely unless a sufficiently large number of the merged firm's customers would not be able to find economical alternative sources of supply, i.e., competitors of the merged firm likely would not respond to the price increase and output reduction by the merged firm with increases in their own outputs sufficient in the aggregate to make the unilateral action of the merged firm unprofitable. Such non-party expansion is unlikely if those firms face binding capacity constraints that could not be economically relaxed within two years or if existing excess capacity is significantly more costly to operate than capacity currently in use.(24)

3. ENTRY ANALYSIS

3.0 Overview

A merger is not likely to create or enhance market power or to facilitate its exercise, if entry into the market is so easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels. Such entry likely will deter an anticompetitive merger in its incipiency, or deter or counteract the competitive effects of concern.

Entry is that easy if entry would be timely, likely, and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern. In markets where entry is that easy (i.e., where entry passes these tests of timeliness, likelihood, and sufficiency), the merger raises no antitrust concern and ordinarily requires no further analysis.

The committed entry treated in this Section is defined as new competition that requires expenditure of significant sunk costs of entry and exit.(25) The Agency employs a three step methodology to assess whether committed entry would deter or counteract a competitive effect of concern.

The first step assesses whether entry can achieve significant market impact within a timely period. If significant market impact would require a longer period, entry will not deter or counteract the competitive effect of concern.

The second step assesses whether committed entry would be a profitable and, hence, a likely response to a merger having competitive effects of concern. Firms considering entry that requires significant sunk costs must evaluate the profitability of the entry on the basis of long term participation in the market, because the underlying assets will be committed to the market until they are economically depreciated. Entry that is sufficient to counteract the competitive effects of concern will cause prices to fall to their premerger levels or lower. Thus, the profitability of such committed entry-must be determined on the basis of premerger market prices over the long-term.

A merger having anticompetitive effects can attract committed entry, profitable at premerger prices, that would not have occurred premerger at these same prices. But following the merger, the reduction in industry output and increase in prices associated with the competitive effect of concern may allow the same entry to

occur without driving market prices below premerger levels. After a merger that results in decreased output and increased prices, the likely sales opportunities available to entrants at premerger prices will be larger than they were premerger, larger by the output reduction caused by the merger. If entry could be profitable at premerger prices without exceeding the likely sales opportunities--opportunities that include pre-existing pertinent factors as well as the merger-induced output reduction--then such entry is likely in response to the merger.

The third step assesses whether timely and likely entry would be sufficient to return market prices to their premerger levels. This end may be accomplished either through multiple entry or individual entry at a sufficient scale. Entry may not be sufficient, even though timely and likely, where the constraints on availability of essential assets, due to incumbent control, make it impossible for entry profitably to achieve the necessary level of sales. Also, the character and scope of entrants' products might not be fully responsive to the localized sales opportunities created by the removal of direct competition among sellers of differentiated products. In assessing whether entry will be timely, likely, and sufficient, the Agency recognizes that precise and detailed information may be difficult or impossible to obtain. In such instances, the Agency will rely on all available evidence bearing on whether entry will satisfy the conditions of timeliness, likelihood, and sufficiency.

3.1 Entry Alternatives

The Agency will examine the timeliness, likelihood, and sufficiency of the means of entry (entry alternatives) a potential entrant might practically employ, without attempting to identify who might be potential entrants. An entry alternative is defined by the actions the firm must take in order to produce and sell in the market. All phases of the entry effort will be considered, including, where relevant, planning, design, and management; permitting, licensing, and other approvals; construction, debugging, and operation of production facilities; and promotion (including necessary introductory discounts), marketing, distribution, and satisfaction of customer testing and qualification requirements.(26)

Recent examples of entry, whether successful or unsuccessful, may provide a useful starting point for identifying the necessary actions, time requirements, and characteristics of possible entry alternatives.

3.2 Timeliness of Entry

In order to deter or counteract the competitive effects of concern, entrants quickly must achieve a significant impact on price in the relevant market. The Agency generally will consider timely only those committed entry alternatives that can be achieved within two years from initial planning to significant market impact.(27) Where the relevant product is a durable good, consumers, in response to a significant commitment to entry, may defer purchases by making additional investments to extend the useful life of previously purchased goods and in this way deter or counteract for a time the competitive effects of concern. In these circumstances, if entry only can occur outside of the two year period, the Agency will consider entry to be timely so long as it would deter or counteract the competitive effects of concern within the two year period and subsequently.

3.3 Likelihood of Entry

An entry alternative is likely if it would be profitable at premerger prices, and if such prices could be secured by the entrant.(28) The committed entrant will be unable to secure prices at premerger levels if its output is too large for the market to absorb without depressing prices further. Thus, entry is unlikely if the minimum viable scale is larger than the likely sales opportunity available to entrants.

Minimum viable scale is the smallest average annual level of sales that the committed entrant must persistently achieve for profitability at premerger prices.(29) Minimum viable scale is a function of expected revenues, based upon premerger prices,(30)

and all categories of costs associated with the entry alternative, including an appropriate rate of return on invested capital given that entry could fail and sunk costs, if any, will be lost.(31)

Sources of sales opportunities available to entrants include:

- (a) the output reduction associated with the competitive effect of concern,(32)
- (b) entrants' ability to capture a share of reasonably expected growth in market demand,(33)

(c) entrants' ability securely to divert sales from incumbents, for example, through vertical integration or through forward contracting, and (d) any additional anticipated contraction in incumbents' output in response to entry.⁽³⁴⁾ Factors that reduce the sales opportunities available to entrants include: (a) the prospect that an entrant will share in a reasonably expected decline in market demand, (b) the exclusion of an entrant from a portion of the market over the long term because of vertical integration or forward contracting by incumbents, and (c) any anticipated sales expansion by incumbents in reaction to entry, either generalized or targeted at customers approached by the entrant, that utilizes prior irreversible investments in excess production capacity. Demand growth or decline will be viewed as relevant only if total market demand is projected to experience long-lasting change during at least the two year period following the competitive effect of concern.

3.4 Sufficiency of Entry

Inasmuch as multiple entry generally is possible and individual entrants may flexibly choose their scale, committed entry generally will be sufficient to deter or counteract the competitive effects of concern whenever entry is likely under the analysis of Section 3.3. However, entry, although likely, will not be sufficient if, as a result of incumbent control, the tangible and intangible assets required for entry are not adequately available for entrants to respond fully to their sales opportunities. In addition, where the competitive effect of concern is not uniform across the relevant market, in order for entry to be sufficient, the character and scope of entrants' products must be responsive to the localized sales opportunities that include the output reduction associated with the competitive effect of concern. For example, where the concern is unilateral price elevation as a result of a merger between producers of differentiated products, entry, in order to be sufficient, must involve a product so close to the products of the merging firms that the merged firm will be unable to internalize enough of the sales loss due to the price rise, rendering the price increase unprofitable.

4. Efficiencies

Competition usually spurs firms to achieve efficiencies internally. Nevertheless, 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.

Efficiencies generated through merger can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, merger-generated efficiencies may enhance competition by permitting two ineffective (e.g., high cost) competitors to become one effective (e.g., lower cost) competitor. In a coordinated interaction context (see Section 2.1), marginal 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. In a unilateral effects context (see Section 2.2), marginal 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. 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.

The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies.⁽³⁵⁾ Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical.

Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by the merging firms may not be realized. Therefore, the merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific. Efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. Cognizable efficiencies are assessed net of costs produced by the merger or incurred in achieving those efficiencies.

The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market.⁽³⁶⁾ To make the requisite determination, the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market. In conducting this analysis,⁽³⁷⁾ the Agency will not simply compare the magnitude of the cognizable efficiencies with the magnitude of the likely harm to competition absent the efficiencies. The greater the potential adverse competitive effect of a merger--as indicated by the increase in the HHI and post-merger HHI from Section 1, the analysis of potential adverse competitive effects from Section 2, and the timeliness, likelihood, and sufficiency of entry from Section 3--the greater must be cognizable efficiencies in order for the Agency to conclude that the merger will not have an anticompetitive effect in the relevant market. When the potential adverse competitive effect of a merger is likely to be particularly large, extraordinarily great cognizable efficiencies would be necessary to prevent the merger from being anticompetitive.

In the Agency's experience, efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great. Efficiencies almost never justify a merger to monopoly or near-monopoly.

The Agency has found that certain types of efficiencies are more likely to be cognizable and substantial than others. For example, efficiencies resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the marginal cost of production, are more likely to be susceptible to verification, merger-specific, and substantial, and are less likely to result from anticompetitive reductions in output. Other efficiencies, such as those relating to research and development, are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions. Yet others, such as those relating to procurement, management, or capital cost are less likely to be merger-specific or substantial, or may not be cognizable for other reasons.

5. FAILURE AND EXITING ASSETS

5.0 Overview

Notwithstanding the analysis of Sections 1-4 of the Guidelines, a merger is not likely to create or enhance market power or to facilitate its exercise, if imminent failure, as defined below, of one of the merging firms would cause the assets of that firm to exit the relevant market. In such circumstances, post-merger performance in the relevant market may be no worse than market performance had the merger been blocked and the assets left the market.

5.1 Failing Firm

A merger is not likely to create or enhance market power or facilitate its exercise if the following circumstances are met: 1) the allegedly failing firm would be unable to meet its financial obligations in the near future; 2) it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act;⁽³⁸⁾ 3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition of the assets of the failing firm⁽³⁹⁾

that would both keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger; and 4) absent the acquisition, the assets of the failing firm would exit the relevant market.

5.2 Failing Division

A similar argument can be made for "failing" divisions as for failing firms. First, upon applying appropriate cost allocation rules, the division must have a negative cash flow on an operating basis. Second, absent the acquisition, it must be that the assets of the division would exit the relevant market in the near future if not sold. Due to the ability of the parent firm to allocate costs, revenues, and intracompany transactions among itself and its subsidiaries and divisions, the Agency will require evidence, not based solely on management plans that could be prepared solely for the purpose of demonstrating negative cash flow or the prospect of

exit from the relevant market. Third, the owner of the failing division also must have complied with the competitively-preferable purchaser requirement of Section 5.1.

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1. 15 U.S.C. Section 18 (1988). Mergers subject to section 7 are prohibited if their effect "may be substantially to lessen competition, or to tend to create a monopoly."
 2. 15 U.S.C. Section 1 (1988). Mergers subject to section 1 are prohibited if they constitute a "contract, combination or conspiracy in restraint of trade."
 3. 15 U.S.C. Section 45 (1988). Mergers subject to section 5 are prohibited if they constitute an "unfair method of competition."
 4. These Guidelines update the Merger Guidelines issued by the U.S. Department of Justice in 1984 and the Statement of Federal Trade Commission Concerning Horizontal Mergers issued in 1982. The Merger Guidelines may be revised from time to time as necessary to reflect any significant changes in enforcement policy or to clarify aspects of existing policy.
 5. For example, the burden with respect to efficiency and failure continues to reside with the proponents of the merger.
 6. Sellers with market power also may lessen competition on dimensions other than price, such as product quality, service, or innovation.
 7. Probable supply responses that require the entrant to incur significant sunk costs of entry and exit are not part of market measurement, but are included in the analysis of the significance of entry. See Section 3. Entrants that must commit substantial sunk costs are regarded as "committed" entrants because those sunk costs make entry irreversible in the short term without foregoing that investment; thus the likelihood of their entry must be evaluated with regard to their long-term profitability.
 8. Although discussed separately, product market definition and geographic market definition are interrelated. In particular, the extent to which buyers of a particular product would shift to other products in the event of a "small but significant and nontransitory" increase in price must be evaluated in the context of the relevant geographic market.
 9. Throughout the Guidelines, the term "next best substitute" refers to the alternative which, if available in unlimited quantities at constant prices, would account for the greatest value of diversion of demand in response to a "small but significant and nontransitory" price increase.
 10. The terms of sale of all other products are held constant in order to focus market definition on the behavior of consumers. Movements in the terms of sale for other products, as may result from the behavior of producers of those products, are accounted for in the analysis of competitive effects and entry. See Sections 2 and 3.
 11. For example, in a merger between retailers, the relevant price would be the retail price of a product to consumers. In the case of a merger among oil pipelines, the relevant price would be the tariff--the price of the transportation service.
 12. This arbitrage is inherently impossible for many services and is particularly difficult where the product is sold on a delivered basis and where transportation costs are a significant percentage of the final cost.
 13. If uncommitted entrants likely would also remain in the market and would meet the entry tests of timeliness, likelihood and sufficiency, and thus would likely deter anticompetitive mergers or deter or counteract the competitive effects of concern (see Section 3, *infra*), the Agency will consider the impact of those firms in the entry analysis.
 14. Under other analytical approaches, production substitution sometimes has been reflected in the description of the product market. For example, the product market for stamped metal products such as automobile hub caps might be described as "light metal stamping," a production process rather than a product. The Agency believes that the approach described in the text provides a more clearly focused method of incorporating this factor in merger analysis. If production substitution among a group of products is nearly

universal among the firms selling one or more of those products, however, the Agency may use an aggregate description of those markets as a matter of convenience.

15. Where all firms have, on a forward-looking basis, an equal likelihood of securing sales, the Agency will assign firms equal shares.

16. The constraining effect of the quota on the importer's ability to expand sales is relevant to the evaluation of potential adverse competitive effects. See Section 2.

17. For example, a market consisting of four firms with market shares of 30 percent, 30 percent, 20 percent and 20 percent has an HHI of 2600 ($30^2 + 30^2 + 20^2 + 20^2 = 2600$). The HHI ranges from 10,000 (in the case of a pure monopoly) to a number approaching zero (in the case of an atomistic market). Although it is desirable to include all firms in the calculation, lack of information about small firms is not critical because such firms do not affect the HHI significantly.

18. The increase in concentration as measured by the HHI can be calculated independently of the overall market concentration by doubling the product of the market shares of the merging firms. For example, the merger of firms with shares of 5 percent and 10 percent of the market would increase the HHI by 100 ($5 \times 10 \times 2 = 100$). The explanation for this technique is as follows: In calculating the HHI before the merger, the market shares of the merging firms are squared individually:

$(a)^2 + (b)^2$. After the merger, the sum of those shares would be squared: $(a + b)^2$, which equals $a^2 + 2ab + b^2$. The increase in the HHI therefore is represented by $2ab$.

19. But excess capacity in the hands of non-maverick firms may be a potent weapon with which to punish deviations from the terms of coordination.

20. Similarly, in a market where product design or quality is significant, a firm is more likely to be an effective maverick the greater is the sales potential of its products among customers of its rivals, in relation to the sales it would obtain if it adhered to the terms of coordination. The likelihood of expansion responses by a maverick will be analyzed in the same fashion as uncommitted entry or committed entry (see Sections 1.3 and 3) depending on the significance of the sunk costs entailed in expansion.

21. Similarly, in some markets sellers are primarily distinguished by their relative advantages in serving different buyers or groups of buyers, and buyers negotiate individually with sellers. Here, for example, sellers may formally bid against one another for the business of a buyer, or each buyer may elicit individual price quotes from multiple sellers. A seller may find it relatively inexpensive to meet the demands of particular buyers or types of buyers, and relatively expensive to meet others' demands. Competition, again, may be localized: sellers compete more directly with those rivals having similar relative advantages in serving particular buyers or groups of buyers. For example, in open outcry auctions, price is determined by the cost of the second lowest-cost seller. A merger involving the first and second lowest-cost sellers could cause prices to rise to the constraining level of the next lowest-cost seller.

22. Information about consumers' actual first and second product choices may be provided by marketing surveys, information from bidding structures, or normal course of business documents from industry participants.

23. The timeliness and likelihood of repositioning responses will be analyzed using the same methodology as used in analyzing uncommitted entry or committed entry (see Sections 1.3 and 3), depending on the significance of the sunk costs entailed in repositioning.

24. The timeliness and likelihood of non-party expansion will be analyzed using the same methodology as used in analyzing uncommitted or committed entry (see Sections 1.3 and 3) depending on the significance of the sunk costs entailed in expansion.

25. Supply responses that require less than one year and insignificant sunk costs to effectuate are analyzed as uncommitted entry in Section 1.3.

26. Many of these phases may be undertaken simultaneously.

27. Firms which have committed to entering the market prior to the merger generally will be included in the measurement of the market. Only committed entry or adjustments to pre-existing entry plans that are induced by the merger will be considered as possibly deterring or counteracting the competitive effects of concern.

28. Where conditions indicate that entry may be profitable at prices below premerger levels, the Agency will assess the likelihood of entry at the lowest price at which such entry would be profitable.
29. The concept of minimum viable scale ("MVS") differs from the concept of minimum efficient scale ("MES"). While MES is the smallest scale at which average costs are minimized, MVS is the smallest scale at which average costs equal the premerger price.
30. The expected path of future prices, absent the merger, may be used if future price changes can be predicted with reasonable reliability.
31. The minimum viable scale of an entry alternative will be relatively large when the fixed costs of entry are large, when the fixed costs of entry are largely sunk, when the marginal costs of production are high at low levels of output, and when a plant is underutilized for a long time because of delays in achieving market acceptance.
32. Five percent of total market sales typically is used because where a monopolist profitably would raise price by five percent or more across the entire relevant market, it is likely that the accompanying reduction in sales would be no less than five percent.
33. Entrants' anticipated share of growth in demand depends on incumbents' capacity constraints and irreversible investments in capacity expansion, as well as on the relative appeal, acceptability and reputation of incumbents' and entrants' products to the new demand.
34. For example, in a bidding market where all bidders are on equal footing, the market share of incumbents will contract as a result of entry.
35. The Agency will not deem efficiencies to be merger-specific if they could be preserved by practical alternatives that mitigate competitive concerns, such as divestiture or licensing. If a merger affects not whether but only when an efficiency would be achieved, only the timing advantage is a merger-specific efficiency.
36. Section 7 of the Clayton Act prohibits mergers that may substantially lessen competition "in any line of commerce . . . in any section of the country." Accordingly, the Agency normally assesses competition in each relevant market affected by a merger independently and normally will challenge the merger if it is likely to be anticompetitive in any relevant market. In some cases, however, the Agency in its prosecutorial discretion will consider efficiencies not strictly in the relevant market, but so inextricably linked with it that a partial divestiture or other remedy could not feasibly eliminate the anticompetitive effect in the relevant market without sacrificing the efficiencies in the other market(s). Inextricably linked efficiencies rarely are a significant factor in the Agency's determination not to challenge a merger. They are most likely to make a difference when they are great and the likely anticompetitive effect in the relevant market(s) is small.
37. The result of this analysis over the short term will determine the Agency's enforcement decision in most cases. The Agency also will consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market. Delayed benefits from efficiencies (due to delay in the achievement of, or the realization of consumer benefits from, the efficiencies) will be given less weight because they are less proximate and more difficult to predict.
38. 11 U.S.C. Sections 1101-1174 (1988).
39. Any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets--the highest valued use outside the relevant market or equivalent offer to purchase the stock of the failing firm--will be regarded as a reasonable alternative offer.

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Annex III: List of interviewees, acknowledgements

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8. Derrick Rill, Office of Public Affairs, Federal Trade Commission, drill@ftc.gov.

7 Endnotes

¹ Source: U.S. Census Bureau, State and County Quick Facts. Data derived from Population Estimates, 2000 Census of Population and Housing, 1990 Census of Population and Housing and other Census data-gathering programs.

² Sources: U.S. Census Bureau, State and County Quick Facts and the White House Social Statistics Briefing Room at <http://www.whitehouse.gov/fsbr/demography.html> and <http://quickfacts.census.gov/qfd/states/00000.html>.

³ Source: White House Social Statistics Briefing Room.

⁴ The percentage reporting themselves as “white”—but not of Hispanic lineage—was lower: 69.1%.

⁵ Source: White House Social Statistics Briefing Room.

⁶ Ibid.

⁷ U.S. Census, 1997 estimates.

⁸ Source: United Nations Development Programme, 2001 at <http://www.undp.org/hdr2001/hdi.pdf>.

⁹ Both parties tend to gravitate to the middle of the political spectrum to engage moderate voters; however, the Republican party tends to attract more social and political conservatives, while the Democrats have in the past been the patrons of organized labor and have favored a mixed economy and progressive social policies.

¹⁰ Eugene P. Seskin and Stephanie H. McCulla, “Annual Revision of the National Income and Product Accounts,” Department of Commerce, Bureau of Economic Analysis, August 2002.

¹¹ Jeanine Aversa, “Economy Grows at 1.1 Percent Rate,” Associated Press, Aug. 29, 2002.

¹² Ibid.

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¹⁴ Source: U.S. Department of Commerce press release, “U.S. International Trade in Goods and Services,” May 2002.

¹⁵ Source: U.S. Department of Labor press release, “The Unemployment Situation: July 2002,” released Aug. 2, 2002.

¹⁶ Martin I. Hamburg and Stuart N. Brotman, *Communications Law and Practice* (New York: Law Journal Seminars-Press, 1995), p. 1.21.

¹⁷ Ibid., p. 1.22.

¹⁸ Ibid.

¹⁹ Ibid.

²⁰ Ibid. at p. 1.23.

²¹ Ibid.

²² Ibid. at p. 1.24.

²³ Ibid., citing *Central Union Telephone Co.*, 1920B Pub. Util. Rep. (PUR) 813, 847-848 (Ind. Pub. Serv. Comm’n 1920).

²⁴ Independent telephone companies did remain, however, in many areas of the U.S. Some of those were unified under GTE, Sprint and other national companies, while others served particular cities, such as Rochester Tel, in Rochester, N.Y.

²⁵ Hamburg and Brotman at 1.26, citing *Microwave Communications, Inc.* 18 F.C.C. 2d 953 (1969).

²⁶ Report on the pending Communications Act of 1995 (later enacted as the Telecommunications Act of 1996), submitted by U.S. Rep. Thomas Bliley (R., VA), of the Commerce Committee, U.S. House of Representatives, July 24, 1995.

²⁷ The MFJ, as its name suggests, was actually a modification of an earlier judgment obtained against AT&T, dating from 1956.

²⁸ After several horizontal mergers, only four remain in 2002: Verizon (formerly NYNEX Corp. and Bell Atlantic Corp.), BellSouth Corp., SBC Communications, Inc., (formerly Southwestern Bell Co., Ameritech Corp., and Pacific Telesis Corp.) and Qwest Communications, Inc. (formerly US WEST, Inc.).

²⁹ The MFJ set up artificial regions dubbed “local access and transport areas” or “LATAs,” which corresponded with no technical limits or existing political or economic boundaries; they were wholly arbitrary. The RBOCs were forbidden to carry calls from one LATA to another—thus, they could not provide “interLATA” service. Within any given LATA, however, there was no limit on the ability of the Bell companies to provide toll services. Thus, it is technically inaccurate to say the Decree kept the RBOCs out of the “long distance” market.

³⁰ Source: “*Federal Communications Commission Releases Data on Local Telephone Competition*,” FCC press release, July 23, 2002.

³¹ CLEC access lines were not spread uniformly across the country. Only a handful of states had in excess of 1 million CLEC access lines at the end of 2001: California, Illinois, New York, Pennsylvania and Texas.

³² See *Local Phone Competition: Status as of December 31, 2001*, FCC Wireline Competition Bureau, Industry Analysis and Technology Division, July 2002, page 1.

³³ *Ibid.* at page 2.

³⁴ *Ibid.*, Table 2.

³⁵ *Ibid.* Table 3.

³⁶ See *Trends in Telephone Service*, FCC Wireline Competition Bureau, Industry Analysis and Technology Division, May 2002, page 10-1.

³⁷ *Ibid.*, Table 10.1.

³⁸ *Ibid.* Table 10.9.

³⁹ See “Can MSN Play David to AOL’s Goliath?” BusinessWeek Online, August 5, 2002, at http://www.businessweek.com/print/magazine/content/02_31/b3794107.htm?mainwindow.

⁴⁰ See *Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996*, Third Report, CC Docket 98-146, rel. February 6, 2002, separate statement of Commissioner Kathleen Q. Abernathy.

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⁴³ *Ibid.*, Table 5.

⁴⁴ See “FCC Adopts Annual Report on State of Competition in the Wireless Industry,” FCC press release, June 13, 2002.

⁴⁵ See *Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, Seventh Report, Rel. July 3, 2002 (FCC 02-179)(*Wireless Competition Report*) at pages 13-14.

⁴⁶ *Ibid.* page 23.

⁴⁷ *Ibid.*, page 22, citing studies by the Cellular Telecommunications and Internet Association, Paul Kagan Associates, Inc., and J.D. Power and Associates.

⁴⁸ *Ibid.* at page 23.

⁴⁹ FCC press release on the *Wireless Competition Report*.

⁵⁰ *Wireless Competition Report* at pages 58-59.

⁵¹ *Ibid.*, page 33.

⁵² *Ibid.*, citing Yuki Noguchi, “Verizon Connections Decline,” *Washington Post*, September 11, 2001.

⁵³ See 15 U.S.C. § 1.

⁵⁴ See 15 U.S.C. § 2.

⁵⁵ See 15 U.S. C. § 18A.

⁵⁶ In 1927, Congress had enacted the Radio Act, placing control of broadcasting and other radio communications under the control of the Federal Radio Commission, which was authorized to reconcile competing uses of radio frequencies by allocating blocks of frequencies for certain uses and issuing licenses. Along with the Interstate Commerce Commission, on the wireline common carrier side, the FRC was the conceptual precursor of the FCC.

⁵⁷ See 47 U.S.C. § 151.

⁵⁸ Michael K. Kellogg, John Thorne and Peter W. Huber, *Federal Telecommunications Law* (Boston: Little, Brown and Co., 1992), page 12.

⁵⁹ See 47 U.S.C. §§201-203

⁶⁰ J. Scott Marcus, "The Potential Relevance to the United States of the European Union's Newly Adopted Regulatory Framework for Telecommunications," FCC, Office of Plans and Policy, Working Paper Series, July 2002, page 5.

⁶¹ Ibid.

⁶² See *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunication Services*, CC Docket No. 01-337, notice of proposed rulemaking, rel. December 20, 2001, at Footnote 9.

⁶³ See *Telecommunications Competition and Deregulation Act of 1995 (S. 652)*, Report of the Committee on Commerce, Science, and Transportation, U.S. Senate, 104th Congress, March 1995.

⁶⁴ The home regions were established at Divestiture (See Section 3.1.2)

⁶⁵ Hamburg and Brotman, page 4.15, citing *Louisiana Public Service Commission v. FCC*, 476 U.S. 355, 369, 106 S. Ct. 1890, 90 L. Ed.2d 369 (1986).

⁶⁶ For purpose of price regulation of incumbent LECs, costs for such "common lines" are allocated through the "jurisdictional separations" process, in order to be recovered through intrastate or interstate services. According to a somewhat arbitrary formula, 25 percent of common-line costs are attributed to interstate services and 75 percent are to be recovered from intrastate usage. In practice, this formula may overstate intrastate costs and functions primarily as a mechanism to subsidize local networks with long distance revenues.

⁶⁷ Kellogg, et al., p. 82.

⁶⁸ See 47 U.S.C. § 152

⁶⁹ Kellogg, et al., page 83.

⁷⁰ Ibid. page 103.

⁷¹ Interview with Montana Public Service commissioner Bob Rowe, August, 2002.

⁷² FCC Commissioners cannot simply ignore the express wishes of the White House--or rather, it would not be considered wise to do so. The White House officially nominates commissioners (often at legislators' recommendations) and an open break with the Executive Branch would leave any Chairman politically isolated in Washington.

⁷³ The website of the California Public Utilities Commission, for example, notes that it regulates "privately owned electric, telecommunications, natural gas, water and passenger transportation companies, in addition to household goods movers and the safety of rail transit" (See <http://www.cpuc.ca.gov/>).

⁷⁴ A provision of the Telecommunications Act (47 U.S.C. § 332) indicates that state or local decisions on tower siting by wireless carriers cannot have the effect of preventing the provision of mobile services. In practice, however, companies often face community hostility to new towers, expressed through delays and even refusals to grant building permits.

⁷⁵ See *Application of WorldCom, Inc., and MCI Communications Corp. for Transfer of Control of MCI Communications Corp. to WorldCom*, CC Docket No. 97-211, memorandum opinion and order, 13 FCC Rcd 18025 at 18033-34.

⁷⁶ See J. Scott Marcus, "The Potential Relevance to the United States of the European Union's Newly Adopted Regulatory Framework for Telecommunications," published by the FCC's Office of Plans and Policy, July 2002, at page 19.

⁷⁷ See *Policy and Rules Concerning Rates for Competitive Common Carrier Service and Facilities Authorizations Therefore*, CC Docket No. 79-252, First Report and Order, 85 F.C.C. 2d 1 (1980).

⁷⁸ See *Policy and Rules Concerning Rates for Competitive Common Carrier Service and Facilities Authorizations Therefore*, CC Docket No. 79-252, Fourth Report and Order 95 F.C.C. 2d 554 (1983) at ¶ 7.

⁷⁹ See *Motion of AT&T Corp. To Be Reclassified as a Non-Dominant Carrier*, order, 11 FCC Rcd 3271 (1995) at ¶ 22.

⁸⁰ *Ibid.* at ¶ 38.

⁸¹ *Ibid.* at ¶ 39.

⁸² *Ibid.* at ¶ 5, citing *Competitive Carrier* First Report and Order at ¶¶ 20-21.

⁸³ See, *inter alia*, *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, CC Docket No. 96-149, Second Report and Order, 12 FCC Rcd 15756 (1997).

⁸⁴ See *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Service*, CC Docket No. 01-337, notice of proposed rulemaking, rel. Dec. 20, 2001.

⁸⁵ The FCC regulates some international carriers licensed in the U.S. as dominant if those carriers are affiliated with a foreign carrier that is deemed to possess market power on the foreign end of an international route.

⁸⁶ Marcus, page 21.

⁸⁷ See *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers, etc.*, order, 14 FCC Rcd 14221 (1999).

⁸⁸ See *Report of the Committee on Commerce, Science, and Transportation on S. 652, the Telecommunications Competition and Deregulation Act of 1995*, U.S. Senate, rel. March 30, 1995, page 5: "In addition, the measure requires telecommunications carriers with market power over telephone exchange and exchange access services to open and unbundle network features and functions to allow any customer or carrier to interconnect with the carrier's facilities."

⁸⁹ See 15 U.S.C. §§18 and 21(a).

⁹⁰ In a separate statement, dissenting in part from the FCC's decision in the SBC-Ameritech merger, then-Commissioner Harold Furchtgott-Roth wrote, "By this Order, the Commission imposes legally dubious, overbroad, potentially unenforceable, privately negotiated conditions on a merger that it is statutorily unauthorized to review, and [the] assessment of which was governed by no clear procedural or substantive standards." See *Applications of Ameritech Corp., Transferor, and SBC Communications, Inc., Transferee, for Consent to Transfer Control of Corporations Holding Commission Licenses and Lines Pursuant to Sections 214 and 310(d) of the Communications Act*, CC Docket 98-141, Separate Statement of Commissioner Harold Furchtgott-Roth Concurring in Part, Dissenting in Part, 14 FCC Rcd at 15174.

⁹¹ See *Applications of Ameritech Corp. and SBC Communications, Inc., for Consent to Transfer Control of Corporations Holding Commission Licenses and Lines, etc.*, CC Docket No. 98-141, memorandum opinion and order, 14 FCC Rcd 14712 (1999) at 14854.

⁹² Section 601(b)(1) of the Telecommunications Act.

⁹³ See *Covad Communications Co. et al. v. BellSouth Corp.*, Case No. 01-16064, U.S. Court of Appeals for the Eleventh Circuit, 299 F.3d 1272 (2002).

⁹⁴ *Ibid.*

⁹⁵ *Richard Goldwasser, et al. v. Ameritech Corp.*, 222 F.3d 390 (2000) at 391.

⁹⁶ *Ibid.* at 401.

⁹⁷ See *Law Office of Curtis V. Trinko, L.L.P. v. Bell Atlantic Corp.*, 294 F.3d 307 (2002).

⁹⁸ *Ibid.* at 328.

⁹⁹ Ibid. at 327.

¹⁰⁰ *Covad Communications Co., et al. v. BellSouth Corp.*, 299 F.3d 1272 (2002).

¹⁰¹ See *1992 Horizontal Merger Guidelines*, FTC introduction, available on the commission's website at <http://www.ftc.gov/bc/docs/horizmer.htm>. The guidelines may also be found at the Justice Department's website at <http://www.usdoj.gov/atr/public/guidelines/hmg.htm>.

¹⁰² *Horizontal Merger Guidelines*, Section 0.1

¹⁰³ Ibid., Section 1.0

¹⁰⁴ Ibid., Section 1.1

¹⁰⁵ Ibid., Section 1.32

¹⁰⁶ Ibid., Section 1.41

¹⁰⁷ Ibid., Section 2.1.

¹⁰⁸ Ibid. Section 4.

¹⁰⁹ Ibid.

¹¹⁰ Ibid. Section 5.

¹¹¹ See "FTC Approves AOL/Time Warner Merger with Conditions," FTC press release, December 14, 2000, at <http://www.ftc.gov/opa/2000/12/aol.htm>.

¹¹² *Law Offices of Curtis V. Trinko* at 326.

¹¹³ See *United States Telecom Association, et al., v. FCC*, United States Court of Appeals for the District of Columbia Circuit, 290 F.3d 415 (2002).

¹¹⁴ See *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, CC Docket No. 02-33, Notice of Proposed Rulemaking, rel. February 15, 2002; *Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, CC Docket No. 01-337, Notice of Proposed Rulemaking, rel. December 20, 2001; and *Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338, Notice of Proposed Rulemaking, rel. December 20, 2001.