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Case Nos.:	TT-2002-472 and TT-2002-473

SOUTHWESTERN BELL TELEPHONE COMPANY

CASE NOS. TT-2002-472 and TT-2002-473

SURREBUTTAL TESTIMONY

OF

DR. DEBRA J. ARON

Evanston, Illinois
August 23, 2002

Index

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SOUTHWESTERN BELL TELEPHONE COMPANY
SURREBUTTAL TESTIMONY OF DR. DEBRA J. ARON

I. PURPOSE AND ORGANIZATION OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND POSITION.

A. My name is Debra J. Aron. I am the Director of the Evanston office of LECG, LLC ("LECG") and Adjunct Associate Professor at Northwestern University. My business address is 1603 Orrington Avenue, Suite 1500, Evanston, IL 60201.

Q. PLEASE DESCRIBE LECG.

A. LECG is an economics and finance consulting firm, providing economic expertise for litigation, regulatory proceedings, and business strategy. Our firm is comprised of more than 400 economists and professional staff from academe and business, and has offices in six countries. LECG's practice areas include antitrust analysis, intellectual property, and securities litigation, in addition to specialties in the telecommunications, gas, electric, and health care industries.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS.

A. I received a Ph.D. in economics from the University of Chicago in 1985, where my honors included a Milton Friedman Fund fellowship, a Pew Foundation teaching fellowship, and a Center for the Study of the Economy and the State dissertation fellowship. I was an Assistant Professor of Managerial Economics and Decision Sciences from 1985 to 1992, at the J. L. Kellogg Graduate School of Management, Northwestern University, and a Visiting Assistant Professor of Managerial Economics and Decision Sciences at the Kellogg School from 1993-1995. I was named a National Fellow of the Hoover Institution, a think tank at Stanford University, for the academic year 1992-1993, where I studied innovation and product proliferation in multiproduct firms. Concurrent with my

position at Northwestern University, I also held the position of Faculty Research Fellow with the National Bureau of Economic Research from 1987-1990. At the Kellogg School, I have taught M.B.A. and Ph.D. courses in managerial economics, information economics, and the economics and strategy of pricing. I am a member of the American Economic Association and the Econometric Society, and an Associate member of the American Bar Association. My research focuses on multiproduct firms, innovation, incentives, and pricing, and I have published articles on these subjects in several leading academic journals, including the *American Economic Review*, the *RAND Journal of Economics*, and the *Journal of Law, Economics, and Organization*.

I have consulted on numerous occasions to the telecommunications industry in the U.S. and internationally on competition, pricing, strategic, and regulatory issues. I also teach a master's level course at Northwestern University on competition in information and network industries. I have testified in several states regarding the proper interpretation of Long Run Incremental Cost and its role in pricing; the measurement of competition in local exchange markets; the role of entry barriers; the economic interpretation of pricing and costing standards in the Telecommunications Act of 1996 (TA96 or the Act); limitations of liability in telecommunications; Universal Service; and proper pricing for mutual compensation for call termination. I have also submitted affidavits to the Federal Communications Commission on telecommunications and cable issues, including analyzing the merits of Ameritech's application for authorization under Section 271 of the Telecommunications Act to serve the in-region interLATA market, CC Docket No. 97-137; explaining proper economic principles for recovering the costs of permanent local number portability, CC Docket No. 95-116; explaining the proper economic interpretation of the "necessary and impair" standard of TA96 for determining which elements should be required, Docket No. 96-98; explaining limitations of market shares and price increases for evaluating market power, in MB Docket No. 02-145; and an

analysis of market power in support of Ameritech's petition for Section 10 forbearance from regulation of high-capacity services in the Chicago LATA, CC Docket No. 95-65. I have testified on issues pertaining to winbacks and other competitive pricing activities in Illinois, Michigan and Ohio, and I have submitted a white paper to Public Utility Commission of Texas on these issues in Project No. 24948.

In addition, I have consulted in other industries regarding potential anticompetitive effects of bundled pricing and monopoly leveraging, market definition, and entry conditions, among other antitrust issues, as well as matters related to employee compensation and contracts, and demand estimation. In 1979 and 1980, I worked as a Staff Economist at the Civil Aeronautics Board studying price deregulation of the airline industry. In July 1995, I assumed my current position at LECG. My professional qualifications are detailed in my curriculum vitae, which is attached as Schedule 1 to my testimony.

Q. HAVE YOU TESTIFIED PREVIOUSLY BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes. I testified before the Commission most recently in Case No. TT-2002-227, In the Matter of Southwestern Bell Telephone Company's Proposed Revisions to PSC Mo. No. 26, Long Distance Message Telecommunications Services Tariff. I also testified in Case No. TO-2001-467, In the Matter of the Investigation of the State of Competition in the Exchanges of Southwestern Bell Telephone Company; and in Case No. TA-2001-475, In the Matter of Southwestern Bell Communications Services for a Certificate of Service Authority to Provide Interexchange Telecommunications Services Within the State of Missouri.

Q. DR. ARON, PLEASE BRIEFLY DESCRIBE THE PURPOSE OF THIS PROCEEDING.

A. It is my understanding that this proceeding emanates from a motion filed by Staff of the Missouri Public Service Commission ("Staff") on April 3, 2002.[1] In its motion, Staff alleges that certain "winback" promotions offered by Southwestern Bell Telephone, L.P., d/b/a Southwestern Bell Telephone Company ("SWBT") to its former business and residential customers are anticompetitive and, thus, requests that the Commission reject the promotions. On April 5, 2002, based on Staff's motion, the Commission opened a proceeding to investigate this issue and articulated the purpose of the proceeding as "permit[ting] SWBT, and any other interested parties, an opportunity to respond to Staff's Motion to Suspend and Reject SWBT's tariff" prior to the Commission rendering an Order on the issue.[2]

Q. PLEASE DESCRIBE THE PURPOSE OF YOUR TESTIMONY.

A. The purpose of my testimony is to respond to the allegations and assertions made by Staff and intervenors insofar as their rebuttal testimonies rest on an erroneous understanding of the economics of competition. I explain the proper criteria for determining whether prices are anticompetitive, and the distinction between prices that are anticompetitive and those that benefit consumers and competition but harm competitors. As I will explain in this testimony, as long as the price offers satisfy standard economic criteria (which I will explain), these sorts of offers are the epitome of welfare-enhancing price competition and, thus, benefit consumers in both the near and long term.

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[1] *Staff's Motion to Suspend and Reject SWBT's Tariff* (April 3, 2002) as cited in *Order Suspending Tariff and Establishing Time for Response*, Missouri Public Service Commission, Case Nos. TT-2002-472 and TT-2002-473 (April 5, 2002).

[2] *Order Suspending Tariff and Establishing Time for Response*, Missouri Public Service Commission, Case Nos. TT-2002-472 and TT-2002-473 (April 5, 2002). Subsequent to this Order, the Commission consolidated the proceedings to investigate SWBT's business and residential promotions (*Order to Consolidate*, May 22, 2002) and granted the applications of AT&T and MCI to intervene (*Order Granting Applications For Intervention*, May 10, 2002).

Q. PLEASE DESCRIBE THE ORGANIZATION OF YOUR TESTIMONY.

A. In the following section I articulate the economic and antitrust principles for evaluating winback offers. I explain that there is only one appropriate basis by which to evaluate winback offers, and that is by their anticipated effects on consumer welfare and economic efficiency. Anything else simply favors individual competitors over genuine market competition, to the detriment of consumers themselves.

In Section III, I respond to Staff and intervenors' allegation that SWBT's winback offers discriminate among competitors. I explain that this type of concern is typically and properly analyzed as equivalent to a claim of predatory pricing. I explain that if the elements necessary to prove predation – including pricing below incremental cost, with a reasonable likelihood of excluding competitors, and the ability to later recoup the losses due to predatory pricing – are not met, the claim of predation is without merit. Such is the case in the current proceeding.

In Section IV, I explain that Staff and intervenors' cry for relief – namely, to handcuff SWBT today and harm consumers as a result, in order supposedly to promote competition tomorrow – is equivalent to an "infant industry protection" argument. The "infant industry" rationale encourages policy makers temporarily to handicap incumbents in order to boost a smaller rival's ability to compete and overcome the alleged advantages of incumbency. I explain that there are many pitfalls associated with such regulation. First, and foremost, the CLECs seeking regulatory protection in this proceeding – MCI WorldCom and AT&T – are hardly "infants" for whom such an argument can credibly apply.

In Section V, I explain that consideration of SWBT's current market power in the local exchange market – be it large, small, or non-existent – is not relevant to this proceeding. Market power is relevant to evaluating whether a producer or cartel of producers can increase and maintain its prices above a competitive level without losing so many customers as to make that behavior unprofitable. No party in this proceeding is

alleging any such behavior; SWBT's winback offerings are not alleged to be an attempt to increase price. Thus, allegations that SWBT is somehow abusing its market power are a red herring and should be ignored.

In Section VI, I respond to Staff and intervenors' allegation that winback offers are discriminatory among customers. I explain that these offers benefit some customers and harm none, and are a direct response to the behavior of its competitors and customers. To the extent one can say that discrimination exists in the market, it is on the part of the CLECs, who pick and choose which areas and which customers they wish to target. SWBT is not dictating market behavior, but responding to it in a pro-competitive manner.

Finally, in Section VII, I summarize the winback/retention-related proceedings in other states. Of the cases I was able to obtain, I find that no other state Commission has condemned winbacks or found them to be per-se anticompetitive.

Q. WHAT ECONOMIC PRINCIPLES GOVERN YOUR ANALYSIS OF THE ISSUES IN THIS PROCEEDING?

A. There are two major themes I wish to convey in this testimony. First, while Staff and intervenors object to price competition from SWBT's winback offerings, this Commission should welcome that competition because it is good for Missouri consumers both in the near and long term. To be sure, lower prices may be harmful to *competitors*; and these competitors have a very real incentive to complain about such prices to any authority willing to listen to their theories. The Commission should not, however, confuse or equate the welfare of competitors with the welfare of Missouri consumers. The idea that Missouri consumers should be required to forego short-term benefits in order to achieve some alleged long-term benefits is simply a false tradeoff, as there is no long-term benefit to be gained absent a showing that winback offers would exclude efficient competitors. In the absence of such prices having such an exclusionary effect, there is no need to forego the short-term benefits at all.

Second, as I will explain, the potential for the pricing behavior in question to have anticompetitive (exclusionary) effects that harm consumers depends on whether the prices are predatory, which requires a showing that they are *below cost*. If the pricing in question is not predatory then it may be harmful to competitors' profits, but it poses no problem for competition or consumer welfare, and the Commission should not discourage or prevent it.

If the Commission accepts the position of Staff and intervenors, or in any way restricts the availability of SWBT's winback offerings, it will be moving away from the benefits of competition and towards a regulatory model that deprives consumers in Missouri of the opportunity to benefit from lower prices in the short run and the long run. Protecting competitors from genuine price competition contravenes the competitive process and harms consumers.

II. WINBACK OFFERS SHOULD BE EVALUATED BASED ON THEIR IMPACT ON CONSUMER WELFARE AND ECONOMIC EFFICIENCY

Q. OFFICE OF PUBLIC COUNSEL ("OPC") WITNESS MS. MEISENHEIMER CONTRIBUTES THE FOLLOWING INSIGHT REGARDING THE PURPOSE OF WINBACK MARKETING: A FIRM'S WINBACK OFFER "IS TO ULTIMATELY INCREASE PROFITS."[3] PLEASE RESPOND TO AND EXPAND UPON THIS CHARACTERIZATION.

A. It is an elementary and generally accepted premise of economics that all competitive behavior, including winback marketing, is motivated by profits. The profit motive is a fundamental tenet of economics; it articulates the social welfare foundations of the competitive market and our economic system. As explained in every introductory economics course, it is the profit motive that is the key driver for consumer welfare.

[3] *Rebuttal Testimony of Barbara A. Meisenheimer*, Case Nos. TT-2002-472 and TT-2002-473, July 26, 2002, p. 4. (Hereafter referred to as *OPC Rebuttal*.)

Expanding upon this observation, firms market winback offers to attract customers back from a competitor by making the customer aware of a service or pricing package that is responsive to the competitor's offers and the customers' needs. Firms provide winback pricing to convey to consumers the firm's willingness to compete for their business in a way that is responsive to their competition. While the objectives of a winback offer are clearly counter to the interests of *competitors*, they are neither anticompetitive nor antithetical to consumer welfare. To the contrary, they are the very epitome of competition and beneficial to consumers.

Q. INTERVENORS INTRODUCE A MYRIAD OF ARGUMENTS ALLEGING THAT SWBT'S WINBACK OFFERS ARE ANTICOMPETITIVE. HOW DO YOU RESPOND TO THESE ALLEGATIONS?

A. Winback offers are a form of price competition. Indeed, TA96 is based on the belief that market-driven price competition is a viable alternative to regulation and will benefit telecommunications consumers.[4] Price cutting is almost always detrimental to *competitors*, but only very rarely is it detrimental to *competition*. Socially harmful price-cutting scenarios are very much the exception rather than the norm; while beneficial, pro-consumer and pro-competitive price-cutting is the norm rather than the exception.

It is intuitive that price decreases benefit consumers. Even price decreases that drive competitors out of the market benefit consumers and are not necessarily symptomatic of anticompetitive behavior or any long-run harm to consumers, absent other relevant facts. On the contrary, in competitive markets, social welfare is enhanced when inefficient firms who rely on artificially high prices are forced out of the market by competitors who cut prices to appropriate, competitive levels. Competition laws do not,

[4] The statutory objective is articulated in the preamble of TA96 as follows: "To promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies."

and should not, seek to protect the profit margins of inefficient firms or to subsidize inefficient new entrants at the expense of consumers.

From an economic perspective, there is only one appropriate basis by which to evaluate winback offers, and that is by their anticipated effects on consumer welfare and economic efficiency. Anything else simply favors individual competitors over genuine market competition, to the detriment of consumers themselves. This axiom of welfare economics is nicely summarized by Judge Robert Bork, a noted and highly respected authority and author on antitrust theory, in his discussion of the role of economic analysis in competition policy in an antitrust setting. Judge Bork rejects policy goals other than that of improving consumer welfare:

> A multiplicity of policy goals in the law seems desirable to some commentators, though they do not address the question of whether the goals contradict one another and how such contradictions are to be resolved in deciding specific cases. … These are positions I wish to dispute. The antitrust laws, as they now stand, have only one legitimate goal, and that goal can be derived as rigorously as any theorem in economics.
>
> This chapter and the next advance a pair of related propositions:
>
> (1) The only legitimate goal of American antitrust law is the maximization of consumer welfare; therefore,
>
> (2) "Competition," for purpose of antitrust analysis, must be understood as a term of art signifying any state of affairs in which consumer welfare cannot be increased by judicial decree.[5]

Judge Bork's analysis provides useful counsel both to antitrust authorities and to any policy maker who must evaluate proposals based on their purported effects on competition. I wish to emphasize one of Judge Bork's conclusions: the term "competition" is not infinitely malleable, nor can a proposed regulation reasonably increase genuine competition if the effect of the proposal is to help some rivals at the expense of

[5] Bork, Robert H., *The Antitrust Paradox: A Policy at War with Itself*, New York: The Free Press, 1978 (1993), p. 51. (Hereafter referred to as *Bork*.)

others without serving consumers. Increases in genuine competition correspond to increases in consumer welfare. When this correspondence fails, it means that the increase in (apparent) competition exacts a cost on society that exceeds any social benefits brought about through increased rivalry. This is why, as a matter of policy, antitrust tribunals do not necessarily seek to maximize rivalry by simply seeking to increase the number of providers. To do so would not necessarily increase genuine competition and would, in fact, reduce society's wealth, if public policy protected firms from price competition at the expense of consumers.

Q. STAFF WITNESS MR. THOMAS OPINES THAT "THE TERM ANTICOMPETITIVE IS NOT AN ACCUSATION OF ANTI-TRUST VIOLATIONS." HE CONCLUDES BY STATING THAT "[I]N MY OPINION, ANTICOMPETITIVE IS A TERM USED TO DESCRIBE ACTIONS THAT MAY POSSIBLY DISCOURAGE COMPETITION IN A GIVEN MARKETPLACE."[6] PLEASE RESPOND TO THIS CHARACTERIZATION.

A. Mr. Thomas's view is without merit, and without support in any recognized literature of which I am aware (and he cites to none). The long history of antitrust analysis and practice in the US has been focused on defining and distinguishing those behaviors that are in fact anticompetitive and are, *therefore,* an antitrust violation. If Mr. Thomas wishes to discard the accumulated body of analysis and experience of professional economists, expert agencies, and antitrust courts in favor of his own theory of "anticompetitive" practice, I believe he owes it to this Commission to articulate what such theory is. I suspect it would treat as "anticompetitive" that which harms competitors, even if it does not harm competition. As I explain in this testimony, antitrust theory has rejected this approach and the Commission should do so as well.

Q. STAFF WITNESS MR. THOMAS WARNS THAT A CURRENT PROCEEDING UNDERWAY AT THE FEDERAL COMMUNICATIONS COMMISSION ("FCC") "COULD POTENTIALLY RESULT IN THE REMOVAL OF

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[6] *Rebuttal Testimony of Christopher C. Thomas,* Case No. TT-2002-472, July 26, 2002, p. 3. (Hereafter referred to as *Staff Rebuttal*.)

INCUMBENT UNBUNDLING OBLIGATIONS, RESULTING IN INCREASED REGULATORY UNCERTAINTY FOR MANY COMPETITIVE COMPANIES."[7] PLEASE RESPOND TO MR. THOMAS' CONCERN.

A. If the FCC removes an unbundling obligation for a particular element in a particular geographic area, it will be because, as provided in the Act, lack of access to such element from the incumbent at regulated rates does not impair the ability of CLECs to compete. Hence, while such an eventuality may be harmful to some CLECs (particularly, those who have built their business plan around uneconomically low regulated UNE prices), it would not be harmful to competition but rather would be a step in the direction of increased competition. In any event, the FCC's actions in implementing the Act provides no basis for rejection of a tariff which benefits consumers such as these proposed by SWBT.

Q. STAFF WITNESS MR. THOMAS PROCEEDS TO SUGGEST THAT THE ONLY REASON CUSTOMERS REMAIN WITH SWBT IS BECAUSE OF "FACTORS SUCH AS THEIR PERCEPTIONS OF EITHER SEARCH COSTS OR RISK."[8] IS THIS AN EXHAUSTIVE DESCRIPTION OF WHY CUSTOMERS CHOOSE NOT TO SWITCH TO A CLEC?

A. No. Mr. Thomas ignores the fact that many CLECs are apparently not interested in serving some of SWBT's customer base and design their price offerings to appeal only to those customers that are the most lucrative. A case in point is the "Neighborhood" plan, offered by Mr. Price's employer. MCI WorldCom's Neighborhood plan is an "all you can eat" local/long distance offering for $55.99 per month in Missouri, which is geared to heavy residential and small business telecommunications users in Missouri who are willing to pay for features such as voice mail, who make relatively many long-distance calls, and who therefore contribute the most to the financing of the underlying network; and is specifically designed *not* to appeal to those residential customers who have less revenue-generating usage patterns. Moreover, if a customer is already paying a price at which, given her usage patterns, she is apparently not very lucrative, I see no reason that

[7] *Staff Rebuttal*, p. 4.

[8] *Staff Rebuttal*, p. 7.

competitive forces would be expected to induce that customer's current provider to further decrease prices to her.

Q. AT&T WITNESS MR. KOHLY OPINES THAT IN SEEKING THE ABILITY TO OFFER WINBACK PROMOTIONS, SWBT IS "SEEKING PROTECTIONISM BY ASKING THE REGULATORS TO INSULATE SWBT FROM RATE REDUCTIONS AND COMPETITION."[9] WHAT IS YOUR RESPONSE TO THIS ASSERTION?

A. It is a remarkable feat of logic by which Mr. Kohly can argue that seeking the opportunity to respond to competition in the way that firms in this and other industries routinely and legitimately do amounts to a request for "protection." SWBT is seeking the ability to offer lower prices (specifically, waive certain non-recurring charges) to customers who are, apparently, most attractive to CLECs and who have demonstrated themselves to be responsive to and interested in competitive solicitations. The desire to respond to competition in this way is evidence of the fact that SWBT is emphatically not insulated from competition.

Q. COULD YOU PROVIDE EXAMPLES OF WINBACK OFFERS IN THIS AND OTHER INDUSTRIES?

A. Winback offers are common in the long-distance telephony market, as well as in non-telecommunications markets such as computer software, magazine subscriptions, and Internet access. As many consumers are aware, AT&T itself pioneered the practice of sending checks to customers for up to $100, which are only redeemable if the customer switches long distance service to AT&T. AT&T reportedly differentiates among customers by varying the amount of the offer according to individual characteristics, such as age, income, and education, or perhaps by making no offer at all.[10] This form of targeted marketing is no more or less "discriminatory" than the winback marketing at issue

[9] *Rebuttal Testimony of R. Matthew Kohly*, Case Nos. TT-2002-472 and TT-2002-473, July 26, 2002, p. 8. (Hereafter referred to as *AT&T Rebuttal*.)

[10] Dow Jones Interactive, "Win-back Checks Create Long-Distance Junkies," Capital Publications, Inc., July 17, 1995.

in this proceeding. I understand from SWBT witness Mr. Hughes' surrebuttal testimony that AT&T is currently engaging in this practice in Missouri, specifically targeted to its former long-distance customers in order to win them back.

III. WINBACK OFFERINGS WOULD NOT SUCCEED AS A PREDATORY STRATEGY

Q. A FUNDAMENTAL FEATURE OF STAFF AND INTERVENOR TESTIMONY IS AN ALLEGATION THAT SWBT'S WINBACK OFFERS ARE HARMFUL TO COMPETITORS AND THAT THE HARM INFLICTED ON COMPETITORS WILL ULTIMATELY BE BORNE BY CONSUMERS VIA A REDUCTION IN OR ELIMINATION OF COMPETITION. WOULD YOU PLEASE COMMENT ON THIS APPROACH?

A. Although Staff and intervenors never explicitly recognize or acknowledge it, their complaint is essentially one of predatory pricing. Predatory pricing is the term used to describe alleged behavior in which a firm attempts to exclude competition by setting so low a price that its only motivation could be exclusion. In turn, it should be noted that claims of predatory pricing are viewed with great skepticism under antitrust analysis. Because market-driven price decreases are universally beneficial to consumers in the short run (and are an inherent feature of competition), the courts have taken a cautious approach to inferring that cutting prices is anticompetitive. This is evident in the survey contained in *Antitrust Law Developments, 4th edition,* a publication of the American Bar Association, a standard reference for practicing antitrust attorneys and economists.[11] For example, in *Matsushita Elec. Indus. Co. v. Zenith Radio Corp,* the Supreme Court wrote:

> [C]utting prices in order to increase business often is the very essence of competition. Thus, mistaken inferences in cases such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect. "[W]e must be concerned lest a rule or precedent that

[11] ABA Section of Antitrust Law, *Antitrust Law Developments,* 4th ed. (1997). (Hereafter referred to as *Antitrust Law Developments*).

> authorizes a search for a particular type of undesirable pricing behavior end up by discouraging legitimate price competition."[12]

History is replete with false claims of competition being overly fierce or competition being "ruinous" not only to individual firms but also to the very market process itself. As renowned antitrust experts Areeda and Hovenkamp correctly point out, competitors always want to discourage one another from decreasing prices because all of the firms can benefit if they can jointly sustain higher prices in the market.[13] Given the opportunity, competitors will bring their suspicions and grievances to a sympathetic governing arm. The universal remedy suggested by the aggrieved in such instances is a price maintenance plan that is sponsored, rather than attacked, by governmental authority. The Commission should recognize the intervenors' position for the same.

Q. DR. ARON, PLEASE EXPLAIN HOW ECONOMISTS APPROACH ALLEGATIONS OF PREDATORY PRICING.

A. There are three necessary elements to a claim of predatory pricing. First, the price must be below the provider's own cost, properly defined, of providing the product or service. Second, there must be a reasonable likelihood that the alleged predatory behavior will in fact exclude the competitors in the market. And third, because pricing below cost necessitates incurring a loss for the period of predatory behavior, there must be a realistic likelihood of recouping the foregone profits. In fact, the antitrust literature considers market conduct in which a firm meets its rival's price only for those customers offered the competitor's price (i.e., a "meeting competition" clause), and concludes that it is a valid defense against the sort of allegations presented in this proceeding, even if the prices are below cost.[14]

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[12] Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986) (citations omitted), as quoted in *Antitrust Law Developments,* Volume I, p. 252.

[13] Areeda, Phillip, and Herbert Hovenkamp. *Antitrust Law: An Analysis of Antitrust Principles and Their Application*, Aspen Publishers, Inc. (2002), Volume III, p. 282. (Hereafter referred to as *Areeda and Hovenkamp*)

[14] *Areeda and Hovenkamp*, Volume III, ¶ 748, p. 506.

Economists have long recognized that attempts at predatory or exclusionary pricing are rarely successful because of the difficulty of recouping forgone profits that were incurred during the period of exclusionary pricing. If the firm cannot recoup these losses, the pricing strategy can only harm the firm adopting it, although it benefits consumers. Recouping losses requires that the firm be able to set prices substantially above costs for an extended period of time after successful exclusion. This requires that the firm have the ability to set high retail prices and erect sufficient entry barriers that these high retail prices would not induce (re)entry. In practice, these circumstances have not often been found in unregulated markets, and the regulatory requirements for interconnection, unbundling, and resale (all at regulated rates imposed on ILECs) under TA96, as well as the sunk nature of carriers' own facilities, make these conditions even less likely to be satisfied in local telecommunications markets in the United States.

If neither exclusion nor recoupment is plausible, predatory pricing is not rational and the observed prices are generally assumed not to be anticompetitive even without evaluating whether the prices are below cost. One reason that predatory pricing is found infrequently is that the kind of market and regulatory structure that would permit recoupment is uncommon. This economic logic has been recognized by the courts:

> In recent years, predatory pricing cases have turned to an increasing extent upon an analysis of whether the market structure will permit the predator to recoup the losses it initially sustains from below-cost pricing by means of supracompetitive pricing after predation has achieved its object. The unlikelihood of recoupment was a significant factor in the Supreme Court's analysis in *Matsushita Electric Industrial Co. v. Zenith Radio Corp* [475 U.S. 574 (1986)]. As the Court stated in *Matsushita*:
>
> > The success of any predatory scheme depends on *maintaining* monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain. Absent some assurance that the hoped-for monopoly will materialize, *and* that it can be sustained for a significant period of time, "[t]he predator must make a substantial investment with no assurance that it will pay off." For this

> reason, there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful.[15] (emphasis in original)

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> In *A.A. Poultry Farms v. Rose Acre Farms* [881 F.2d 1396 (7th Cir. 1989), *cert. denied*, 494 U.S. 1019 (1990)], the Seventh Circuit put the recoupment issue first, thus avoiding the need to address the complex question of below-cost pricing. The court explained:
>
> > It is much easier to determine from the structure of the market that recoupment is improbable than it is to find the cost a particular producer experiences in the short, middle, or long run (whichever proves pertinent). Market structure offers a way to cut the inquiry off at the pass, to avoid the imponderable questions that have made antitrust cases among the most drawnout and expensive types of litigation. Only if market structure makes recoupment feasible need a court inquire into the relation between price and cost.[16]

Q. HOWEVER, OPC WITNESS MS. MEISENHEIMER ASSERTS THAT THE LOCAL TELECOMMUNICATIONS MARKET IS "UNUSUAL." IN PARTICULAR, SHE CLAIMS THAT, UNLIKE OTHER MARKETS, THE CHARACTERISTICS OF THE LOCAL EXCHANGE SERVICE AND CONSUMER DEMAND POSE A "POTENTIAL THREAT TO CONSUMERS OR EMERGING COMPETITION."[17] IN LIGHT OF THIS CLAIM, MIGHT PREDATORY PRICING BE A LEGITIMATE CONCERN IN THE LOCAL EXCHANGE MARKETPLACE?

A. No, I believe such concern is entirely unwarranted. As I have indicated, the market structure in telecommunications in Missouri makes recoupment improbable, if not impossible. First, even if SWBT were to succeed in excluding rivals, it could not increase retail rates with impunity. SWBT operates under price caps for residential and business local exchange services[18] and under Total Element Long-Run Incremental Cost (TELRIC)

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15 *Antitrust Law Developments,* Volume I, pp. 264-65 (footnotes omitted).

16 *Antitrust Law Developments,* Volume I, p. 266 (footnotes omitted).

17 *OPC Rebuttal,* p. 8.

18 RSMo 2000, Section 392.245.

guidelines for wholesale services, which limit the ability to increase prices. This makes it very difficult for any would-be predator to recoup the forgone profits. Moreover, even in those instances where SWBT's services are not subject to price caps[19] there are regulatory constraints in place to prevent recoupment. For instance, Section 392.245.5, RSMo. 2000 provides the Commission the ability to reimpose price-cap regulation if it determines that effective competition no longer exists.

Second, even if SWBT were able to increase retail prices, new carriers could (re)-enter via purchasing Unbundled Network Elements (UNEs), which would still be available at cost-based rates. The Commission and the FCC have verified that SWBT has complied with the market opening requirements of the Act when they approved SWBT's petition for 271 relief.[20]

Third, while price caps and UNEs protect against recoupment, resale is an important element that protects against exclusion. No matter how low retail rates fall, CLECs can provide service by purchasing available wholesale services at a discount off of the retail rate. In fact, it is my understanding that the winback offerings at issue in this proceeding are available to CLECs for resale, at a discount. Consistent with the intent of Congress in drafting TA96, the FCC made clear that it considers the wholesale

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[19] In Case No. TO-2001-467, SWBT sought and achieved competitive classification for business and residential local services in designated geographies in Missouri. The effect of this decision was to remove the services from the price-cap basket and cease price-cap regulation of the services.

[20] In March 2001, in Case No. TO-99-227 (In the Matter of the Application of Southwestern Bell Telephone Company to Provide Notice of Intent to File an Application for Authorization to Provide In-Region InterLATA Services originating in Missouri Pursuant to Section 271 of the Telecommunications Act of 1996), the Commission determined the Missouri local markets are open to competition. In its *Order*, the Commission stated

> The 14-point competitive checklist sets out the steps that a BOC must take to open the local market to its competitors. See 47 U.S.C. § 271 (c)(2)(B)(i)-(xiv). SWBT has satisfied the requirements of the competitive checklist by providing or offering access to and interconnection with its network on terms and conditions that satisfy each of the checklist items." (p. 64.)

requirements imposed on the RBOCs to be "powerful tools to dismantle the legal, operational and economic barriers that frustrated competitive entry in the past."[21]

Fourth, to the extent that CLECs have invested in their own facilities, much of this investment (such as outside plant) may be sunk. It will not disappear when a CLEC leaves the market, making re-entry relatively low-cost. Hence, the necessary conditions precedent to a claim of primary-line price discrimination are simply not credible in this market. Under such conditions, the undeniable short-run benefits to consumers of the lower winback prices are not in danger of being reversed by recoupment later.

Q. HAS ANY EVIDENCE BEEN PRESENTED BY STAFF OR INTERVENORS THAT DEMONSTRATE SWBT'S PROMOTIONS TO BE BELOW COST?

A. No. Neither Staff nor intervenors have actually claimed that the proposed winback prices are below cost, nor proffered any evidence to support a claim of predatory pricing. Consistent with my above description of predation, the proper method to examine a waiver of installation and other nonrecurring charges would consider the anticipated profit on the entire package of services purchased by the customer over the timeframe the customer is expected to be a subscriber and determine whether that revenue flow is adequate to cover the provider's incremental costs of providing those services. No party to this proceeding has claimed that such a test would fail, let alone conducted an actual analysis and made it part of the record for examination. In fact, as explained in the direct testimony of SWBT witness Mr. Regan, CLECs frequently waive nonrecurring charges to their customers, which provides further indication that SWBT's promotions are not predatory.

[21] Federal Communications Commission, Memorandum Opinion and Order, FCC No. 97-346, released October 1, 1997, ¶ 2.

Q. MCI WORLDCOM WITNESS MR. PRICE IDENTIFIES THREE REASONS WHY SWBT'S WINBACK PROMOTIONS ARE ANTICOMPETITIVE.[22] WHAT ARE THESE REASONS?

A. The three aspects of SWBT's winback promotions Mr. Price asserts are anticompetitive are the following:

(1) The promotions are "based on an anti-competitive abuse of information to which SWBT has preferential access to [*sic*] by virtue of its historic monopoly";

(2) The promotions "represent an exercise of market power by SWBT [and, therefore], cannot be matched by any CLEC"; and

(3) The promotions "unreasonably discriminate between similarly situated customers" and thus are "a threat to the competitive process."

Q. PLEASE RESPOND TO EACH POINT IN TURN.

A. Mr. Price's first argument is not an economic one and is addressed in the surrebuttal testimony of SWBT witness Mr. Regan.

Mr. Price's second point is a non sequitur. The extent of SWBT's market power has absolutely nothing to do with whether its winback promotions can be matched by its competitors. Whether the offering can be matched by any CLEC depends on whether the offer is below the CLEC's cost, taking into account all of the revenues associated with the offer, and the associated incremental costs. Moreover, even if the CLEC could *not* match the offer because it was below the CLEC's cost, that is not sufficient to render the offer anticompetitive – the CLEC may simply be less efficient, and therefore, have higher costs, than the incumbent. It is not in society's interest to protect inefficient competitors. Hence, the standard for anticompetitive pricing requires that the price be below the *incumbent's own* cost. Any CLEC equally or more efficient than the incumbent could

[22] *Rebuttal Testimony of Don Price*, Case Nos. TT-2002-472 and TT-2002-473, July 26, 2002, p. 14. (Hereafter referred to as *MCI WorldCom Rebuttal*.)

viably match such offers, and any CLEC who could not match would be suffering from its own inefficiency. And as I mentioned above, CLECs do typically engage in similar pricing behavior in this respect by waiving nonrecurring charges to their customers.

I address Mr. Price's third point at length in Section V of this testimony. In general, targeted price offerings, such as SWBT's promotions, reflect normal, legitimate business goals and do not imply anticompetitive intent. SWBT's promotions are a response to competition and, thus, predicated on CLEC behavior. It is illogical to argue that in *responding* to selective CLEC behavior SWBT is engaging in discrimination, while the CLEC is not. Moreover, I explain that selective pricing or price discrimination is not a threat to competition unless the selectively-offered price is below cost. Once again, such a claim has not been made in this case.

IV. CONSUMERS ARE NOT SERVED BY "INFANT INDUSTRY" REGULATIONS

Q. STAFF AND INTERVENORS ARGUE THAT IN LIGHT OF SWBT'S ALLEGED "DOMINANT" POSITION IN THE LOCAL EXCHANGE MARKETPLACE IN MISSOURI, SWBT "NEEDS TO BE SUBJECT TO MORE STRINGENT REGULATORY OVERSIGHT IF EFFECTIVE COMPETITION IS TO SURVIVE AND PROSPER."[23] WHAT IS YOUR RESPONSE TO THIS CONCERN?

A. First, I observe that SWBT is, indeed, subject to highly stringent regulatory oversight, including all of the unbundling obligations of the Act. Particularly in light of those extraordinary obligations, Staff and intervenors' pleadings can be read as the assertion that by handcuffing SWBT today and harming consumers as a result, competition will be promoted and consumers will, thereby, eventually be compensated for the harm they

[23] *Staff Rebuttal*, pp. 4-5. See, also, *OPC Rebuttal*, p. 9 ("The results of the recent review of the state of competition in SWBT's exchanges in Missouri paints a bleak picture of the success of local competition. Reasonably, this should lead to a reevaluation of the policies necessary to sustain and promote competition in Missouri's local exchange markets."); and *MCI WorldCom Rebuttal*, p. 3 ("The issues presented by SWBT's tariff filing go to the very core of whether the Commission will take the necessary actions to ensure that local telecommunications markets can become competitive, or whether SWBT will be permitted to exercise its market power and effectively remonopolize telecommunications service markets.")

suffered. This rationale equates to the classic "infant industry" argument: often implemented in the form of tariffs to protect a fledgling domestic industry from foreign competition, the "infant industry" rationale encourages policy makers temporarily to handicap incumbents or offer preferences to their less-experienced rivals in order to boost the latter's ability to compete and overcome the alleged advantages of incumbency. There are many pitfalls associated with infant industry regulations, which cause economists, as a whole, to question their wisdom in most circumstances.[24] In this case, the CLECs seeking regulatory protection—MCI WorldCom and AT&T—are hardly "infants" for whom such an argument can credibly apply. While MCI WorldCom's current difficulties are well-known, they are hardly of SWBT's making and it is hardly the responsibility of this Commission to handcuff SWBT and harm consumers out of sympathy for WorldCom's self-made plight.

Q. AT&T WITNESS MR. KOHLY CONTENDS THAT THE EMPIRICAL EVIDENCE OF COMPETITION IN MISSOURI PRESENTED IN SWBT'S DIRECT TESTIMONY IS NOT CONVINCING AND, MOREOVER, ON A NATIONWIDE BASIS "THE STATE OF THE INDUSTRY DOES NOT SUPPORT SWBT'S CLAIMS THAT CLECS CONTINUE TO COMPETE EFFECTIVELY."[25] HOW DO YOU RESPOND TO THIS CONCERN?

A. I do not agree that competition in Missouri and nationwide is floundering. The empirical evidence presented by Mr. Hughes and Mr. Regan is relevant and demonstrates substantial gains by CLECs competing in Missouri despite not only the alleged anticompetitive acts of SWBT, and SWBT winback efforts, but despite the difficult economic environment generally and the limited ability of many CLECS to attract investment funds. It is consistent with detailed analyses I have conducted recently in other states, which show

[24] Kahn, A., and W. E. Taylor, "The Pricing of Inputs Sold to Competitors: A Comment," *Yale Journal on Regulation*, Vol. 11 (1994), pp. 225-240. (Hereafter referred to as *Kahn and Taylor*).

[25] *AT&T Rebuttal*, p. 18.

that when one looks at the actual data rather than the newspaper headlines, CLEC competition continues to grow.

Likewise, on a nationwide basis, competition continues to make strong gains despite the overall economic downturn and the woes of the telecommunications industry. For instance, in a recent report on the CLEC industry, titled *CLEC Report 2002*, New Paradigm Resource Group (NPRG) found that aggregate CLEC revenues have experienced a more than 10-fold increase in the past five years nationwide, growing from $5 billion in 1997 to $53 billion in 2001; and NPRG forecasts CLEC revenues to increase to over $100 billion by 2005.[26] Moreover, in an update of that report issued in May of this year, NPRG concluded that CLECs continue to grow rapidly. In its press release announcing the release of its updated *CLEC Report 2002*, NPRG concluded as follows:

> As demonstrated by every measurement, competitive telecommunications is moving forward, with many more CLECs adapting, surviving and succeeding than failing," said Terry Barnich, New Paradigm Resources Group President. "This is the nature of a competitive market, and NPRG does not believe the current chaos portends the demise of the wider industry.[27]

Therefore, contrary to Mr. Kohly's unsupported allegation, it appears that CLECs can and are competing effectively in the marketplace, even though investors are understandably wary of the telecommunications sector after all of the recent, well-publicized revelations.

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[26] New Paradigm Resources Group Press Release, "New Paradigm Resources Group's CLEC Report 2002™ Finds Competition Will Outlast Downturn," November 26, 2001; downloaded November 30, 2001 from <www.nprg.com/press/releases/112601pr.htm>.

[27] New Paradigm Resources Group Press Release, "New Paradigm Resources Group's CLEC Report 2002™ Finds Competitive Local Telecom Still Growing," May 28, 2002; downloaded July 19, 2002 from <www.nprg.com/press/releases/052802clecreport.htm>.

Q. ASIDE FROM THE MARKET REALITIES YOU HAVE DISCUSSED, ARE THERE ANY OTHER SERIOUS PROBLEMS WITH INFANT INDUSTRY PROTECTIONISM?

A. Yes. In general, it is difficult to eliminate the preferential treatment once the "upstarts" are on their feet. As noted by renowned economist Alfred Kahn and co-author William Taylor, "so long as companies are insulated from competition, they are, to that extent and for that reason, less likely ever to grow up and attain the ability to compete without such special protections."[28] Other costs associated with infant industry protection are that they distort incentives by, in part, encouraging potential entrants to devote a large portion of their energies to rent seeking; by which I mean, litigating and lobbying to obtain and perpetuate preferential subsidies and protections, rather than concentrating on providing superior service to consumers at attractive prices. Moreover, any regulation that protects a class of competitor from competition imposes a cost stemming from its interference with the efficient distribution of supply among competitors on the basis of their relative costs.

Q. MCI WORLDCOM WITNESS MR. PRICE QUOTES FROM A RECENT OPINION BY THE US SUPREME COURT TO SUPPORT HIS ALLEGATION THAT SWBT'S UBIQUITOUS NETWORK ENDOWS THE CARRIER WITH "A PALPABLE COMPETITIVE ADVANTAGE."[29] IS THE FACT THAT SWBT IS THE LARGEST FACILITIES-BASED PROVIDER IN ITS SERVICE TERRITORY GROUNDS FOR THE COMMISSION TO REJECT SWBT'S WINBACK OFFERS?

A. No, it certainly is not. Nowhere in the Supreme Court opinion Mr. Price cites does it say anything about winback pricing or in any way support Mr. Price's assertion that winbacks are anticompetitive. Moreover, to the extent that competitors want access to SWBT's network to provide service, the FCC's UNE rules provide that access. The UNE obligations were designed to overcome barriers to entry that the embedded network might create and require ILECs to share their "economies of scale" with CLECs. In fact, in Missouri, CLECs have the opportunity to use SWBT's network at extraordinarily low

[28] *Kahn and Taylor*, p. 234.

[29] *MCI WorldCom Rebuttal*, pp. 4-5.

prices that do not adequately compensate SWBT for the actual costs of providing those elements, which is contrary to Mr. Price's assertion that somehow SWBT's network precludes CLECs from competing effectively against the incumbent.

Q. WHAT EVIDENCE DO YOU HAVE THAT SWBT'S UNE RATES ARE NON-COMPENSATORY?

A. I have conducted my own analysis of SWBT's "historic" costs and compared these amounts to SWBT's UNE prices. The results of this analysis highlight the extent to which SWBT's UNE prices are below the costs the company actually incurred to provide the corresponding network elements in 2001. Figure 1 shows that SWBT loses approximately $7.14 per month for every UNE loop a CLEC leases and approximately $11.31 per month for every UNE-P a CLEC leases.[30]

[30] The analysis in Figure 1 summarizes my computations of annual 2001 costs, including capital costs, based on the FCC's Automated Reporting and Management Information System (ARMIS) data. The ARMIS data reflect expenses and capital allocated to the interstate jurisdiction. My analysis reverses out the effects of the allocations so that I can derive, approximately, the total 2001 expenses and capital incurred by SWBT to provide loops, switching, and transport on a "UNE" basis. UNE costs, on a forward-looking basis may be higher or lower than the costs actually (though approximately) incurred by the company. My conclusions have been corroborated by at least two independent financial analyses. See, for example, Anna-Maria Kovacs, et al., *The Status of 271 and UNE-Platform in the Regional Bells' Territories*, Commerce Capital Markets Equity Research, May 1, 2002. See, also, John Hodulik, et al., *How Much Pain From UNE-P*, UBS PaineWebber Global Equity Research, August 20, 2002.

Figure 1
SWBT's UNE Loop and UNE-P Price-to-Cost Margins

	UNE-L	UNE-P
Price [1]	$15.19	$22.63
ARMIS Cost [2]	$22.33	$33.94
Margin [3]	($7.14)	($11.31)

Source: LECG analysis of FCC ARMIS cost data, and SWBT UNE data.

Note: (1) UNE-L and UNE-P Prices are a line-based weighted average of SWBT's zone-specific (urban-suburban-rural) UNE rates. The UNE-P Price includes a non-recurring charge amortized over 36-months.

(2) Key assumptions: Loop costs are reduced by 19.20% to reflect avoided retail costs; assumed depreciation rates are FCC approved depreciation rates; and assumed cost of capital is12.19%. If one assumed instead the FCC's approved cost of capital of 11.25%, the UNE-L cost would be $21.97 and the UNE-P cost would be $33.52. Also, if we assume instead of the 19.20% avoided retail costs that shedding retail costs is unlikely, and we retain the FCC's depreciation schedule, SWBT's loop costs would be $27.63 and SWBT's UNE-P costs would be $39.25.

(3) The UNE prices are based on FCC depreciation parameters, which are backward looking and contrary to the TELRIC methodology. If, instead, economic depreciation parameters were used this would offset a portion of the negative margins.

In light of these results, Mr. Price's concern that SWBT's network is a "palpable competitive advantage" is misplaced. The benefit to CLECs from utilizing SWBT's network at subsidized rates would simply appear to reinforce and encourage CLECs to underinvest in their own networks.

Q. HAVE ENTRANTS SUCCEEDED IN OTHER INDUSTRIES AGAINST SEEMINGLY ADVANTAGED INCUMBENTS?

A. Yes. The U.S. automobile industry is, in my opinion, a fitting example. The U.S. automobile industry was dominated by the "Big 3" manufacturers (General Motors, Chrysler, and Ford), with non-"Big 3" providers (which, at the time, were essentially all foreign manufacturers) constituting less than a 10 percent share of the U.S. market until the 1960s.[31] Today, however, there are 15 auto manufacturers challenging the Big 3.

[31] Automotive News: *Market Data Book 1985*, p. 26; quoted in Feenstra, Robert C., *Transportation Economics: A Look at the Auto Industry*, ECN 190/TTP 215 Lecture 6, Department of Economics – University of California, Davis; downloaded December 21, 2001 from <http://www.econ.ucdavis.edu/faculty/fzfeens/trans/Transport-lecture6.pdf >.

Collectively, these challengers now supply just over 34 percent of all automobiles purchased in this country.[32] The manner in which new entrants to the U.S. automobile market achieved their success was not facilitated by "infant industry" government intervention to protect and promote foreign manufacturers,[33] but instead was based on the ability of these manufacturers to serve a need that the Big 3 manufacturers had neglected. The upstart manufacturers, for instance, successfully entered the U.S. market by implementing innovative ("just-in-time") manufacturing methods, and offering consumers low priced, high quality cars, with good gas mileage.[34] While the result of this success has clearly been harmful to the Big 3, such as Chrysler – which was nearly driven to bankruptcy before the government stepped in to save the ailing company[35] – it has resulted in significant benefits to consumers. This example is particularly instructive because the auto industry is often thought to be characterized by high "barriers to entry" due to large fixed costs, brand name recognition, installed facilities, specific technical expertise, and huge capital requirements. These factors did not prevent the upstart manufacturers from succeeding, even without the availability of access to competitors' systems and processes as are made available to CLECs through UNEs.

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[32] Automotive News reports a total of 17,177,448 U.S. sales for 2001, of which 5,872,620 were sales of non-"Big 3" providers. Automotive News: *Selected U.S. Car and Light-Truck Sales, December & YTD*, downloaded January 4, 2002 from <www.autonews.com/news.cms?newsId=1269>.

[33] Indeed, on the contrary, U.S. trade policy protected domestic producers. For instance, in 1980 the Big 3 domestic manufacturers had their lowest sales since 1961, and lost $4.2 billion. In response to significant pressure from U.S. government agencies and proposed legislation imposing mandatory import restrictions, the Japanese agreed to Voluntary Export Restraints (VER). The Japanese VERs were in effect April 1981 through March 1994, although Japanese imports fell below the restrictions toward the end of the period because the Japanese automobiles assembled in the U.S. did not count toward the quota. See Cohen, Stephen, *The Route to Japan's Voluntary Export Restraints on Automobiles: An Analysis of the U.S. Government's Decision-Making Process in 1981*, Working Paper No. 20, School of International Service – American University, downloaded January 8, 2002 from <www.gwu.edu/~nsarchiv/japan/scohenwp.htm>. (Hereafter *Cohen.*)

[34] Freedman, Craig, *Arigato - An Economic History of the Japanese Import Invasion into the US*, October 1998, School of Economic and Financial Studies – Macquarie University, Australia, downloaded January 2, 2002 from <www.econ.mq.edu.au/cjes/Freeman_C_10-1998.doc> (hereafter referred to as *Freedman*); see also *Cohen.*

[35] *Freedman*, page 12, note 1.

V. THE ISSUE OF MARKET POWER IN THIS PROCEEDING IS A RED HERRING

Q. PLEASE DESCRIBE INTERVENORS' ALLEGATIONS THAT SWBT'S MARKET POWER CONTRIBUTES TO THE ANTICOMPETITIVE IMPACT OF ITS WINBACK OFFERS.

A. MCI WorldCom witness Mr. Price alleges that the targeting of SWBT's proposed winback offerings only to former customers, as opposed to all new customers, "demonstrates SWBT's market power." More specifically, he claims that SWBT's proposed winback offers are an attempt to exercise said market power, to the detriment of competition.[36] AT&T witness Mr. Kohly makes a similar argument, declaring that the Commission's "ultimate concern" should be the targeting of SWBT's winback offers specifically to CLEC customers, which in turn harm Missouri consumers "because the CLECs do not obtain a footing in their initial markets that allows further expansion."[37]

In this section, I address these allegations and explain why, from an economic standpoint, winback offerings are not indicative of nor confined to firms with market power; and that the degree of SWBT's market power in any particular market (which intervenors and Staff have left undefined) is not relevant in any event, in light of the fact that there is no evidence of the offers being predatory by conventional standards.

Q. DR. ARON, PLEASE DEFINE THE TERM "MARKET POWER."

A. In economics, market power can be defined as "the ability … to raise price above the competitive level without losing so many sales so rapidly that the price increase is unprofitable and must be rescinded."[38]

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36 *MCI WorldCom Rebuttal*, p. 20.

37 *AT&T Rebuttal*, p. 17.

38 W.M. Landes, and R.A. Posner, "Market Power in Antitrust Cases," *Harvard Law Review*, vol. 94 (1981), p. 937. Moreover, the Department of Justice/Federal Trade Commission *1992 Horizontal Merger Guidelines* similarly defines market power as "the ability profitably to maintain prices above competitive levels for a significant period of time," but also note that "[s]ellers with market power also may lessen competition on dimensions other than price, such as product quality, service, or innovation." Such allegations are not being made here. See the introductory section of the guidelines, *1992 Horizontal*

Q. ARE PRICE INCREASES A CONCERN OF INTERVENORS IN THIS PROCEEDING?

A. No. Intervenors are not charging SWBT with increasing its prices, but, rather, object to SWBT reducing its price to those customers that they have lost to a competitor's service. To circumvent the logical inconsistency of a market power argument, intervenors invoke a "foothold" hypothesis, which alleges that SWBT's behavior, while beneficial to consumers in the near term, hinders the development of competition and, thereby, harms consumers in the long term. As I have explained, an economic theory consistent with this allegation is that SWBT is applying its alleged market power through predatory means; that is, the ILEC could expel most or all of its competitors from the market by setting its price below some measure of cost and, subsequent to their expulsion, raise its price to recoup the losses by earning monopoly profits. However, this theory of market power does not appear to apply in this context, because no party in this proceeding has accused SWBT of setting its retail prices in a predatory manner (i.e., below cost) or has explicitly alleged predatory pricing. Aside from the fact that a predatory pricing strategy would be unlikely to succeed in this market in any event, from the perspective of antitrust economics, prices cannot be considered predatory if they are not below an appropriate measure of the carrier's incremental costs.[39]

Hence, a claim of predation would fail at the outset. But if one rejects a predatory pricing theory (which, again, was not explicitly claimed in any event), one is left with a void. I am aware of no other recognized economic theory by which market power could be used in a winback context and lead to an anticompetitive result. Accordingly, we can rule out market power as an issue relevant to assessing the impact of SWBT's winback offerings on competition.

Merger Guidelines [With April 8, 1997, Revisions to Section 4 On Efficiencies], downloaded December 29, 2001 from <http://www.ftc.gov/bc/docs/horizmer.htm>.

[39] *Areeda and Hovenkamp*, Volume III, p. 507.

Q. INTERVENORS, NEVERTHELESS, SUGGEST THAT SWBT COULD USE ITS MARKET POWER TO CROSS-SUBSIDIZE THE WINBACK OFFERS FROM ITS OTHER LOCAL EXCHANGE SERVICES. PLEASE EXPLAIN THE RATIONALE UNDERLYING THIS ARGUMENT AND RESPOND.

A. Ms. Meisenheimer articulates her cross-subsidy allegation as follows:

> Economic theory suggests that these types of offerings may shift competitive costs so that cost recovery is sought from those consumers less likely to switch carriers. Such offerings may also threaten entry and impede growth in the local market.[40]

A cross-subsidy argument, in this context, is without merit for several reasons. First, I am aware of no economic theory, nor have intervenors even articulated any cognizable logic, of a claim that a firm can "shift competitive costs." The idea of "cost shifting" is a relic of rate-of-return regulation, which does not apply to SWBT. Except in the context of rate-of-return regulation, costs are not "shifted," but are incurred in the process of providing a service(s), and there is no incentive to misreport or misspecify the source of cost causation for the purpose of affecting prices.

Second, if the winback prices are not below cost, and no intervenor has even attempted to establish this, then there is no cost that requires "shifting." Third, presuming that services provided to some of SWBT's (non-winback) customers secure a margin greater than that earned on the SWBT's proposed winback offers, such an outcome creates a profit opportunity for CLECs and an invitation to CLECs to compete. The dynamics of competition – the process by which competition works to drive prices toward cost and drive profits down – attracts entrants to markets or customers with supra-competitive prices. Entrants can profitably undercut prices in such markets and attract customers, at the expense of the higher-priced provider. As long as there are supra-competitive prices

[40] *OPC Rebuttal*, p. 8. See, also, *AT&T Rebuttal*, p. 14 ("In essence, SWBT's proposed tariffs would permit SWBT to fund its targeted competitive response from other SWBT customers while its competitors have no such luxury. This unreasonably permits SWBT to preempt competitive entry.")

in the market, CLECs have profit opportunities to pursue and should be encouraged to pursue them rather than seek regulatory protection.

VI. REPLY TO STAFF AND INTERVENOR DISCRIMINATION ALLEGATIONS

Q. MCI WORLDCOM WITNESS MR. PRICE ASSERTS THAT SWBT'S "ABILITY TO LIMIT THE PROMOTION ONLY TO CUSTOMERS THAT HAVE LEFT SWBT DEMONSTRATES SWBT'S MARKET POWER."[41] WHAT IS YOUR RESPONSE TO THIS ALLEGATION?

A. Differential pricing is ubiquitously observed in real markets, from monopolistic to highly competitive, and outside of the textbook world of "perfect competition" is not indicative of any particular amount of market power. We observe differential pricing frequently in service markets (everything from airlines to haircuts) and product markets, at both wholesale and retail levels (volume discounts, coupons, and a host of other examples). A recent article in *The Wall Street Journal* discussed the differential pricing in the food retailing industry today – an industry the article characterizes as "ferocious with new competition among the big food retailers."[42] In general, targeted price offerings, such as SWBT's winback price discounts, reflect normal, legitimate business goals and do not imply anticompetitive intent.

Q. MS. MEISENHEIMER DESCRIBES THREE TYPES OF PRICE DISCRIMINATION.[43] PLEASE COMMENT ON THE RELEVANCE OF THIS DISCUSSION TO THIS PROCEEDING.

A. First, I note that Ms. Meisenheimer's description of the social benefit attributed to the various pricing strategies is simply wrong,[44] as well as largely irrelevant, as she attempts to

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41 *MCI WorldCom Rebuttal*, p. 18.

42 McCarthy, Michael J., "Taking the Value Out of Value-Sized," *The Wall Street Journal*, August 14, 2002, p. D1 ("In many stores the vaunted Economy Size packaging of products ranging from Minute Maid frozen orange juice to Oscar Mayer bologna to Cool Whip can cost more per unit than their smaller counterparts. With ferocious new competition among the big food retailers, the price mismatch is becoming increasingly noticeable.")

43 *OPC Rebuttal*, pp. 4-6.

provide a primer on forms of price discrimination that are not alleged or at issue here. More fundamentally, while Ms. Meisenheimer attempts to describe the various forms of price discrimination, she ignores or is simply unaware of the fact that there is a well-defined approach by which economists and the courts assess the competitive implications of "price discrimination" or price differentiation.

Q. PLEASE EXPLAIN HOW ECONOMIC AND ANTITRUST ANALYSIS ASSESSES PRICE DISCRIMINATION.

A. The antitrust literature characterizes two types of harm that could emanate from targeted or differential pricing, generally referred to as price discrimination: primary-line (i.e., injury to competition in the alleged price discriminator's market) and secondary-line (i.e., injury to competition among firms who are customers of the alleged price discriminator). Primary-line price discrimination is often termed "horizontal" in nature, meaning it is a form of predatory pricing directed at a competing producer(s) (although, obviously the eventual victims are consumers who must pay higher prices). In contrast, secondary-line price discrimination is "vertical" in nature and involves a firm's pricing of its product to various downstream resellers or wholesalers. The alleged anticompetitive conduct in this case, as articulated in the Staff and intervenors' testimony, is a form of primary-line price discrimination.

Q. DR. ARON, PLEASE EXPLAIN THE ANTITRUST TREATMENT OF PRIMARY-LINE PRICE DISCRIMINATION.

A. Differential pricing or price discrimination is not generally considered problematic by economists or by competition authorities unless it has the effect of harming competition. To assess harm to competition, under modern antitrust analysis, primary-line price

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[44] An example is her assertion that there are "limited cases in which some economists may find societal value in [first-degree price discrimination]." To the contrary, it is universally accepted in the economics literature that such a pricing structure produces *the* socially efficient level of output. See, for example, Hal R. Varian, *Intermediate Microeconomics: A Modern Approach*, 3rd Edition (1993), pp. 420-421.

discrimination is treated much the same as predatory pricing. Areeda and Hovenkamp summarize primary-line price discrimination as follows:

> The basic injury requirements in a primary-line case is a showing of a price below the appropriate measure of cost that either drives the injured rival out of the market or else disciplines it to refrain from pricing too competitively. Following this predation period there must be a period of "recoupment" in which the resulting monopoly or oligopoly prices, considering their duration and magnitude, are sufficient to make the predation investment profitable. While proof need not wait until after this recoupment period has occurred, it must show that such recoupment is plausible, given the general market circumstances.[45]

Therefore, to support the allegation that SWBT's winback offerings are injurious to competition, the antitrust literature requires a demonstration that (1) such behavior is predatory (below cost) and (2) it is plausible that the predatory strategy will succeed in excluding (or disciplining) competition and recouping the losses. As I have explained here, these factors do not apply in this case.

Q. AT&T WITNESS MR. KOHLY ALLEGES THAT SWBT'S "ABILITY TO ENGAGE IN TARGETED RESPONSE WILL HARM THE LONG RUN PROSPECTS FOR LOCAL COMPETITION AND DENY THE BENEFITS OF COMPETITION TO THE VAST MAJORITY OF LOCAL CUSTOMERS IN MISSOURI."[46] WHAT IS YOUR RESPONSE TO THIS ALLEGATION?

A. Mr. Kohly has provided no justification by which the Commission should reject the standard analysis of the effects on competition for targeted pricing that I have described. As I have explained, according to that analysis, to conclude that targeted pricing or price discrimination harms competition requires, at a minimum, a showing of below-cost pricing. Intervenors and Staff have failed to articulate any cohesive theory or offer substantive evidence to support their undisciplined claims.

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45 *Areeda and Hovenkamp,* Vol. XIV, ¶ 2332 "Proof of Primary-Line Injury," p. 86 (footnotes omitted).

46 *AT&T Rebuttal*, p. 4.

Q. AT&T WITNESS MR. KOHLY ARGUES THAT SWBT'S WINBACK OFFERINGS ARE CONTRARY TO THE MISSOURI STATUTES IN THAT THEY FAIL TO PROMOTE "FULL AND FAIR COMPETITION."[47] DR. ARON, WHAT IS YOUR RESPONSE TO THIS ALLEGATION?

A. Contrary to AT&T witness Mr. Kohly's assertions, SWBT's winback offers do promote "full and fair competition" and denying them would directly impede "full and fair competition." The nature of competition is that firms respond to the prices of their competitors by attempting to meet or beat the competitors' prices, as long as it is more profitable to do so than to lose the customers. Firms will meet competition by targeting their prices only to those customers whose decisions are most likely to be affected, to the extent they are able to do so. Any former customer served by a CLEC can avail herself of SWBT's winback offerings. These offerings are a response to competition (i.e., they are generally available wherever CLECs choose to compete) and, thus, predicated on CLEC behavior. Moreover, they are a response to customer demand (i.e., they are available to residences and businesses that choose a competitor's offering) and, thus, predicated, as well, on customer behavior. In fact, recent experience demonstrates consumers have valid concerns with CLEC offerings and that the option of returning to the incumbent could be an attractive alternative. An August 10, 2002 article in the New York Times recorded a Springfield, Missouri business customer's frustration with MCI WorldCom's service offerings:

> It was August 2000, and Marc Perkel's software company in Springfield, Mo., was effectively out of business. WorldCom, for some reason, had shut down his phone lines. Angrily, he called customer service, only to be told he was not listed as a customer. He was repeatedly transferred, and he tape recorded the conversation to insure he had a record.
>
> "My phone service was turned off when I was on a trip to San Francisco, and now everybody is telling me that I don't have an account with you," Mr. Perkel told the third representative, according to the recording. "You have my business shut down and nobody there seems to be able to figure out how to turn it back on."

[47] *AT&T Rebuttal*, pp. 12-13.

> The representative was puzzled. "Were you on the WorldCom side possibly?" he asked. "Here, we have all the MCI accounts, that sort of thing. WorldCom, on the other hand, they handle all their accounts."
>
> Mr. Perkel, whose account was eventually found on the MCI side, was stumbling across a problem stemming from WorldCom's acquisition binge: For all its talent in buying competitors, the company was not up to the task of merging them. Dozens of conflicting computer systems remained, local network systems were repetitive and failed to work together properly, and billing systems were not coordinated.[48]

A winback offer from SWBT, in this instance, would likely have benefited Mr. Perkel. In any event, it is nonsensical to assert that such an offer is harmful to "full and fair competition" or would have made Mr. Perkel worse off.

Moreover, winback offers not only encourage more vigorous price competition from CLECs, but they increase the incentive for customers to leave SWBT to try a CLEC. There are at least three reasons for this: just by leaving, customers make themselves eligible for more attractive offers from both SWBT and, possibly, other carriers as well. Second, by signaling their willingness to switch providers customers enhance their own bargaining power and attractiveness to carriers, who in turn more aggressively pursue their business. And third, a customer's perceived risk of leaving SWBT to try a new carrier is reduced if the customer knows he can return to SWBT without paying a non-recurring charge. This encourages customers to "test the waters," to the benefit of CLECs, and to the benefit of full and fair competition.

Q. INTERVENORS AND STAFF ALSO ARGUE THAT WINBACK OFFERS LIMIT THE BENEFITS OF COMPETITION TO A NARROW CLASS OF CONSUMERS AND EXPOSE NON-WINBACK CUSTOMERS TO POTENTIAL RATE INCREASES.[49] DO YOU AGREE?

A. No. It is important to recall again what is and what is not the purpose of typical winback-type offerings. Their purpose is very simple: winback offerings are intended to attract

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[48] Eichenwald, Curt, "For WorldCom, Acquisitions Were Behind Its Rise and Fall," *The New York Time*s, p. A1, August 8, 2002.

[49] *OPC Rebuttal*, p. 9; and *Staff Rebuttal*, p. 8.

customers away from competitors. This purpose may be achieved by providing a price reduction to these customers. The purpose of winback offerings *is not* to increase any customer's price; that is, the price of local service to customers that choose not to entertain a CLEC offering should be unaffected by the existence of winback offers. Therefore, no customer in this market is made worse off when a firm offers a winback price discount, and those customers offered winback price discounts are in fact better off. Price reductions are the very reason why the FCC supports winback offerings,[50] why customers benefit from them, and are direct evidence of competition disciplining prices.

The combination of CLEC behavior and customer choice determines the availability of SWBT's winback offerings, not discrimination by SWBT. By picking and choosing the most attractive geographic locations and customer demographics, CLECs "discriminate" among consumers. In light of the CLECs' targeting strategies, it would simply be an abuse of logic to argue that in *responding* to selective CLEC behavior the ILEC is engaging in discrimination, while the CLEC is not. The customers pursued by the ILEC are those targeted by the CLEC.

VII. SUMMARY OF OTHER STATE WINBACK PROCEEDINGS

Q. MCI WORLDCOM WITNESS MR. PRICE CITES A PRIOR COMMISSION ORDER, WHICH RULED THAT A SWBT WINBACK OFFER WAS ANTICOMPETITIVE. IS THIS ORDER IN LINE WITH THE NUMEROUS WINBACK DECISIONS IN OTHER STATES?

A. No. Of the cases I was able to obtain, with the exception of the Missouri Order cited by Mr. Price, there is no condemnation or finding of anticompetitiveness of winback promotions per se by any state Commission that I am aware of.

[50] Federal Communications Commission, *Order on Reconsideration and Petitions for Forbearance*, FCC 99-223, released September 3, 1999, ¶ 68 – 69.

? **South Carolina.** Although the Commission did implement a 10-day waiting period,[51] the Commission nevertheless concluded that (1) the Win Back promotion did not impede local competition; (2) the "Win Back promotion may actually promote competition, since NewSouth or TriVergent could obtain a BellSouth customer via resale of the Win Back Promotion;"[52] (3) there is no abuse of market position by BellSouth; (4) the Win Back Promotion is not discriminatory; (5) the Win Back Promotion does not violate criteria laid out by the FCC.[53]

? **Tennessee.** At issue was a discount program, not a winback program. BellSouth argued that the discount plan was an unregulated service that need not be tariffed. The Commission determined the plan should have been tariffed, and it fined BellSouth for not charging the tariffed rate for services.

? **Texas.** The Commission has not made a ruling.

? **Florida.** As I understand it, the Florida Commission has opened a generic proceeding, but I am unaware of any final order.[54]

? **Georgia.** CLECs filed comments with the Georgia Public Service Commission alleging various improprieties by BellSouth's winback marketing program, including conveying false information about the customer's new carrier and improper use of proprietary information. The Commission's Interim Order prohibits BellSouth from engaging in winback activities for a seven-day period after the customer switches its local provider pending an investigation of these allegations. It does not terminate the program, nor does it opine that winback marketing in and of itself is in any way harmful to competition.[55]

? **Alabama.** In Alabama, the Commission established a generic proceeding regarding the BellSouth "Full Circle" promotion, which appears to be a winback promotion with a term component, but, again, there is no final order that I could find.[56]

? **Illinois (Z-Tel).** The Commission's Order is an example of a specific, tailored remedy designed to address a particular issue. In that case, Ameritech Illinois was alleged to have an advantage over Z-Tel in winning back customers because it was not providing line loss notification to CLECs as quickly as it was providing them to itself. The Commission's Order restricts Ameritech Illinois from using its line loss information to

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51 *Order Ruling on Complaint*, Southeastern Competitive Carriers Association, NewSouth Communications Corporation and TriVergent Communications vs. BellSouth Telecommunications, Inc., Docket No. 2000-378-C, November 12, 2001, p. 13. (Hereafter referred to as *South Carolina Order*.)

52 *South Carolina Order*, p. 11.

53 *South Carolina Order*, pp. 11-13.

54 Florida Public Service Commission Docket No. 011077.

55 *Interim Order*, Investigation of BellSouth Telecommunications "WinBack" Activities, Georgia Public Service Commission Docket No. 14232-U, pp. 1-2.

56 *Report and Order*, Generic Proceeding In RE: Telephone Rules Governing Promotions, Alabama Public Service Commission Docket No. 27989, April 2, 2001, pp. 1-2.

market to Z-Tel's customers until 17 days after Ameritech Illinois loses that customer to Z-Tel, until the notification process problems are corrected.[57] The order explicitly provides for the removal of these restrictions, however, once the line-loss notification problem is resolved. Moreover, even during the interim period, while the line loss notification problem is being corrected, the Illinois Commission did not order an outright ban on winback marketing. In other words, it appears that the Illinois Commission recognized the pro-competitive effects of winback offers and imposed limitations only to correct a temporary information asymmetry. Finally, I observe that there has been no allegation in Missouri that SWBT's line loss notification system is deficient, and I understand that SWBT employs a different system from that used by Ameritech.

Q. Does this conclude your testimony?

A. Yes.

[57] *Order*, Z-Tel Communications, Inc. vs. Illinois Bell Telephone Company (Ameritech Illinois), Verified Complaint and Request for Emergency Relief Pursuant to Sections 13-514, 13-515, 13-516 of the Illinois Public Utilities Act, Docket No. 02-0160, May 8, 2002, pp. 24-25.