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TELECOMMUNICATIONS

Process by Which Mergers of Local Telephone Companies Are Reviewed



**Resources, Community, and
Economic Development Division**

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The Honorable Mike DeWine
Chairman
The Honorable Herb Kohl
Ranking Minority Member
Subcommittee on Antitrust, Business Rights,
and Competition
Committee on the Judiciary
United States Senate

The Honorable Luis Gutierrez
House of Representatives

One of the primary purposes of the Telecommunications Act of 1996 was to promote competition within telecommunications markets. Since the law was enacted, some large local telephone companies have merged, and other mergers are pending. As a result of your concern that the industry has become more consolidated, you asked us to provide information on (1) the standards and processes under which mergers between local telephone companies are evaluated and approved by governmental bodies and (2) the implementation of this process in the Bell Atlantic-NYNEX merger—the largest local telephone merger completed when we began our work in early 1999—and the effects of the merger that can currently be observed.

Results in Brief

Several governmental bodies review mergers between local telephone companies using varied standards and processes in their analyses. At the federal level, these mergers are reviewed by the Department of Justice and the Federal Communications Commission. Using guidelines that have been developed to evaluate the likely effects of a merger on market concentration and other competitive factors, the Department of Justice, acting as the enforcement agency to review mergers under federal antitrust law, assesses whether a merger may “substantially lessen competition” within the industry. If the Department determines that a merger will substantially harm competition and therefore violates antitrust laws, it can bring a court action—in which it bears the burden of proof—to stop the merger. In contrast, the Federal Communications Commission, the federal agency that regulates the telecommunications industry, primarily examines whether the transfer of licenses and lines from one company to another in a merger is in the “public interest.” To determine

if a merger is in the public interest, the Commission considers several factors, such as the effects of a merger on (1) competition in the industry, (2) the Commission's ability to enforce its obligations under the Communications Act, and (3) the deployment of advanced telecommunications services. If the Commission cannot determine that a merger is in the public interest and accordingly declines to approve a license transfer, merging parties can file a lawsuit—in which they bear the burden of proof—challenging the Commission's decision. State attorneys general and some state public utility commissions also have the authority to review mergers between local telephone companies. Like the Department of Justice, state attorneys general review the potential impact of a merger on competition. Most state utility commissions tend, like the Federal Communications Commission, to focus their reviews on whether a merger is in the public interest.

The Bell Atlantic-NYNEX merger took place in August 1997 after review by several governmental bodies. The merging companies' prior status as regulated monopolies complicated the merger review process. After conducting antitrust reviews, the Department of Justice, a task force of state attorneys general, and individual state attorneys general did not challenge the merger under antitrust law. While the Federal Communications Commission and all the reviewing state utility commissions allowed the merger to go forward, the Federal Communications Commission and four of the five reviewing state commissions imposed conditions on the merged company. Many of these conditions—which, for example, required Bell Atlantic to provide a uniform way for competitors to place orders for services—were aimed at inducing Bell Atlantic to rapidly open its local telephone markets to competitors. While few market effects of the merger are identifiable, Bell Atlantic officials told us that the company has realized the cost savings it expected to gain from the merger.

Background

Much of the nation's telephone infrastructure was built and owned by American Telephone & Telegraph Company (AT&T) from the time the company was formed in 1885 through most of the next century. For most of that time, AT&T was the parent company of many subsidiary companies that provided local and long-distance telephone service throughout the United States and also manufactured telephone equipment. By the early 1980s, AT&T carried roughly 80 percent of the nation's local telephone traffic through its 22 subsidiary Bell Operating Companies, and the remaining 20 percent of local telephone traffic (much of which was

concentrated in rural areas) was carried by a myriad of independent telephone companies unaffiliated with AT&T. Because the Bell Operating Companies and the independent companies held franchises giving them the right to serve geographically distinct areas that did not overlap, very few consumers had a choice of providers for local telephone service.

As technology advanced and regulatory changes opened up telecommunications markets to new entrants, competition began to emerge in the long-distance telephone market. In 1974, the Department of Justice (DOJ) brought an antitrust suit against AT&T alleging that the company was engaging in anticompetitive behavior to the detriment of new competitors in the long-distance and telephone equipment markets. The resolution of that case unfolded in the early 1980s and brought an end to AT&T's domination of the nation's local telephone markets on January 1, 1984—16 months after a court approved the consent decree, known as the Modification of Final Judgment, that the Department of Justice and AT&T had entered into. Under the consent decree, AT&T was required to divest its ownership of the 22 Bell Operating Companies to ensure that AT&T would not have an advantage in the long-distance telephone market through its ownership of the local telephone networks and facilities where all telephone calls originate and terminate.

The 22 Bell Operating Companies were reorganized into seven regional entities—Ameritech Corporation, Bell Atlantic Corporation, BellSouth Corporation, NYNEX Corporation, Pacific Telesis Group (PacTel), Southwestern Bell Corporation (now called SBC Communications Inc.), and US WEST, Inc.—that became known as the “Baby Bells” (see fig. 1). The service territories of the newly formed Baby Bells were, and continue to be, geographically distinct; however, the recent mergers between Bell Atlantic and NYNEX, as well as between SBC and PacTel, have reduced the number of Baby Bells to five.¹ The AT&T consent decree also imposed restrictions on the lines of business that Bell Operating Companies were allowed to enter. For example, these companies were not allowed to enter the long-distance market or to manufacture telephone equipment. The AT&T consent decree did not affect the independent local telephone

¹A merger between SBC and Ameritech, announced in May 1998, is currently pending before federal and state regulatory bodies. In addition, Bell Atlantic announced its intention in July 1998 to merge with GTE Corporation, a non-Bell company that provides local telephone service in 28 states and also provides long-distance, wireless, and Internet access services. In both of these cases, DOJ has tentatively approved consent decrees, and FCC is still reviewing the mergers, although, according to FCC, Bell Atlantic and GTE asked the Commission to defer processing their merger application until those companies make a further submission to the Commission on long-distance issues. In addition, a merger between US WEST and Qwest, a non-Bell communications provider of broadband data and voice services, was announced on July 18, 1999. Ten percent of Qwest's current ownership is held by another Baby Bell company, BellSouth.

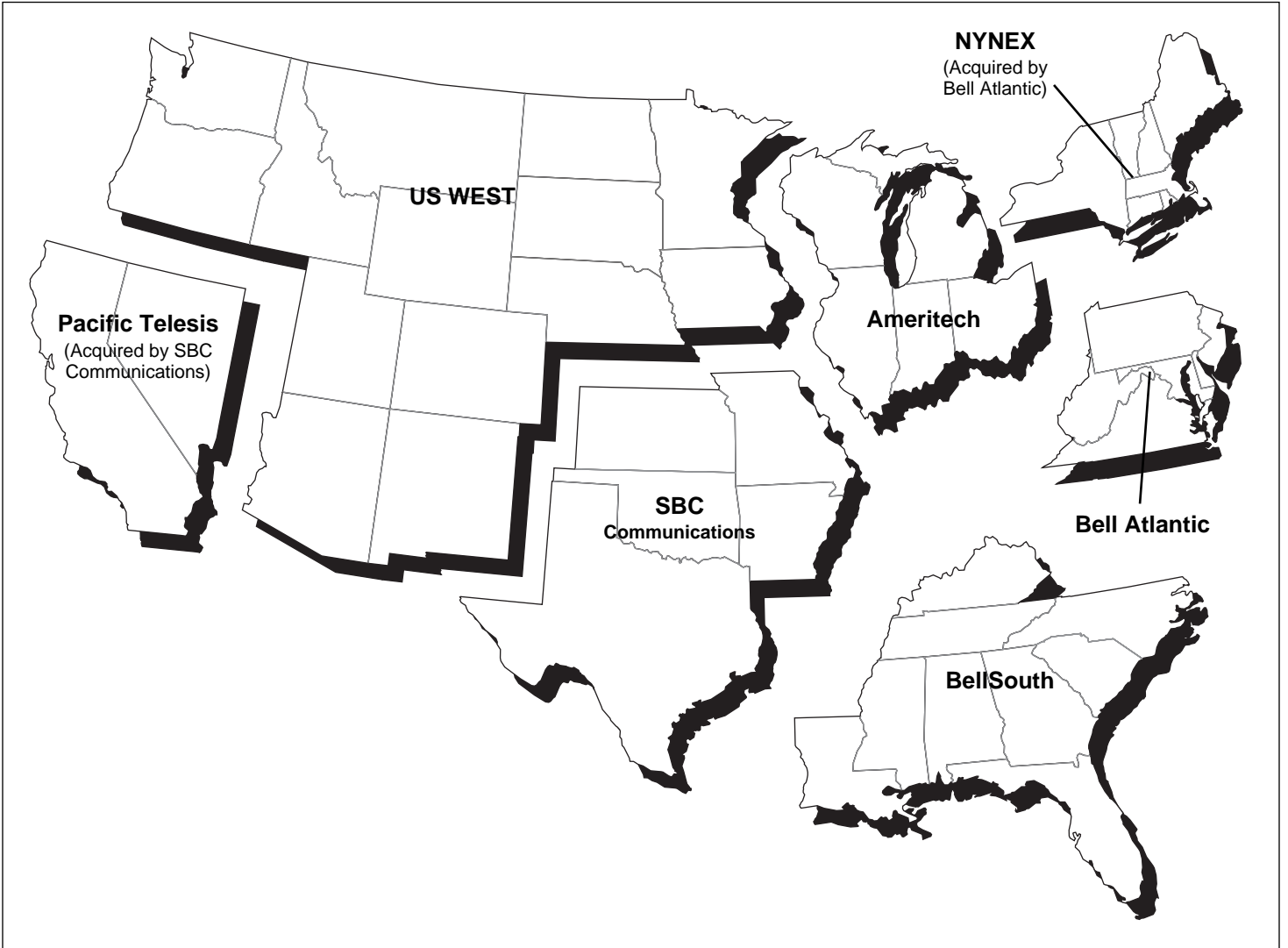
companies that had not been part of AT&T, and their service areas are still distinct and do not overlap Bell service areas.²

Since the AT&T consent decree was issued, advanced technologies have altered the telecommunications market. Recognizing the dramatic changes in the industry, the Congress enacted the Telecommunications Act of 1996. This act was a major modification to the Communications Act of 1934 and set out a framework for the development of competition in local telephone and other telecommunications markets.

At the time Bell Atlantic and NYNEX announced their intention to merge in April 1996, each of the companies controlled approximately 98 percent of the local telephone market in its respective area. Bell Atlantic operated in Delaware, Maryland, New Jersey, Pennsylvania, Virginia, West Virginia, and the District of Columbia, and NYNEX operated in Maine, Massachusetts, New Hampshire, New York, Rhode Island, Vermont, and a portion of Connecticut. The wireless cellular subsidiaries of the two companies had merged in 1994, and discussions on a corporatewide merger between Bell Atlantic and NYNEX were initiated prior to the enactment of the Telecommunications Act of 1996.

²In all 48 states of the continental United States, local telephone service is provided by either a Baby Bell company or an independent local telephone company. Hawaii and Alaska are served only by independent companies.

Figure 1: Service Territories of the Original Seven Regional Bell Operating Companies, With Subsequent Mergers Noted



Note: SNET (a non-Bell company prior to its acquisition by SBC Communications) is the primary local telephone company for most of Connecticut. However, NYNEX (now Bell Atlantic) operated in a small portion of that state.

Governmental Bodies Use Varying Standards and Processes to Review Local Telephone Company Mergers

Federal and state governmental bodies have the authority under different statutory provisions to review proposed mergers of local telephone companies. These varied reviews differ with respect to the purposes of the merger reviews, the reasons mergers can be blocked, the manner in which the governing bodies conduct the reviews, and how any disputes about merger decisions are resolved. Prior to the passage of the 1996 Telecommunications Act, a provision of the 1934 Communications Act provided the Federal Communications Commission (FCC) with the authority to review local telephone company mergers, and FCC could authorize such mergers to go through without review by federal antitrust agencies. This provision was repealed by the 1996 act and, while FCC maintains the authority to review the transfers of licenses that occur with mergers based on other provisions of the Communications Act, DOJ now also reviews mergers between local telephone companies.³ Mergers of telephone companies announced since the 1996 act, such as the Bell Atlantic-NYNEX merger and the SBC-Pacific Telesis merger, have been reviewed by FCC and DOJ at the federal level. State attorneys general and some state utility commissions also have the authority to review proposed mergers of local telephone companies.

Department of Justice. DOJ's Antitrust Division derives its merger review authority from both the Sherman Act of 1890 and the Clayton Act of 1914—the primary federal antitrust laws. These laws are generally designed to preserve competition in an industry sector. Section 7 of the Clayton Act incorporates the policies underlying relevant sections of the Sherman Act and prohibits a merger if the resulting effect “may be to substantially lessen competition.” The Hart-Scott-Rodino Antitrust Improvement Act of 1976, an amendment to the Clayton Act, requires that merging companies, in certain cases,⁴ notify DOJ of their intent to merge and expands DOJ's authority to conduct premerger investigations.

³Generally, federal antitrust reviews are performed by either DOJ or the Federal Trade Commission (FTC) under a cooperative system that will eliminate duplicative merger reviews. In the case of telephone company mergers, DOJ is usually the reviewing agency because a merger of two common carriers—which local telephone companies are—is outside the statutory jurisdiction of FTC, 15 U.S.C. 18, 21, 45(a)(2). Since telephone company mergers are reviewed by DOJ and FCC at the federal level, this report will focus on those agencies.

⁴For example, if the merging parties or the transaction are of sufficient size, a merger will pass certain “thresholds” that require Hart-Scott-Rodino filings to be made.

Operating under specific time frames in conducting its review, DOJ can request further information from the companies that have filed premerger notifications if the Department determines that a more extensive analysis is appropriate. As mandated by law, information that is gathered by DOJ is confidential and protected from public dissemination. To determine whether a merger violates antitrust laws, DOJ uses well-established economic and legal principles that are reflected in the Department's merger guidelines.⁵ The merger guidelines provide methods for several key elements of an antitrust review: defining the relevant markets, measuring concentration, evaluating whether firms are likely to enter a market,⁶ determining competitive effects, and evaluating the efficiencies of a proposed merger. If DOJ determines that a merger will substantially harm competition and therefore violates antitrust laws, it can bring a court action to stop the merger. The burden of proof in such a case is on the government to show that the merger will be substantially anticompetitive. When DOJ concludes that a merger will violate antitrust laws, it may, in some cases, negotiate a "consent decree" with the merging companies. Under a consent decree—which is filed with a court and is thus legally enforceable—the merging companies agree to undertake activities that would eliminate the competitive harm of the merger, such as divesting certain properties. If DOJ does not go to court to block a merger, or if it does not end its investigation with a consent decree or otherwise resolve

⁵DOJ and the FTC's merger guidelines are periodically updated. The most recent update was in 1997.

⁶The evaluation of likely entry includes determining whether one of the merging parties is likely to enter a relevant market.

competitive issues,⁷ the Department will close its investigation.⁸ DOJ generally provides little or no public information about its analyses of a merger's impact on competition.

Federal Communications Commission. FCC's authority to review the transfer of control of licenses in connection with a proposed merger derives from sections 214 and 310 of the 1934 Communications Act.⁹ Because mergers involve a change in the ownership or control of companies holding licenses or lines needed to offer telecommunications services in the United States, merging firms must apply to FCC for approval of the transfer of those licenses or lines. The purpose of FCC's review is to determine that the license transfers are in the "public interest," and this review may consider many factors, such as the competitive effects of the license transfers, the effects on FCC's ability to enforce its obligations under the Communications Act, and the effects on the deployment of advanced telecommunications services. While FCC follows, in part, DOJ's merger guidelines in its competitive analysis of mergers, the Commission's merger review is generally viewed as broader than DOJ's because the public interest standard can take into account a more diverse set of issues and therefore may cause FCC to reach a conclusion that differs from DOJ's. Since a primary purpose of the Telecommunications Act of 1996 was to promote competition in the industry, the Commission's more recent public interest reviews of telephone companies' license transfers have focused closely on competitive effects.

FCC's review of telephone mergers takes place under an open process. All of the documents that companies file with the Commission become part of the public record,¹⁰ parties get a chance to respond to the comments filed by others, and the Commission issues a final order in which it provides a detailed account of its rationale for a decision. When FCC finds a merger to be in the public interest, it will approve the transfers of licenses and lines necessary to allow the merger to go forward. Alternatively, if FCC cannot determine that a merger is in the public interest, it will accordingly decline

⁷In some cases, the Department may agree, informally, to a restructuring of the transaction to eliminate competitive concerns. Also, in some cases, the parties may abandon their intent to merge.

⁸DOJ's decision to not block a merger cannot be challenged in court.

⁹FCC also has the authority under the Clayton Act to review mergers. However, we were told that FCC does not generally exercise its Clayton Act authority. Recently, a number of bills have been introduced to modify FCC's authority to review the transfers of licenses occurring through mergers.

¹⁰However, part of the public record may include confidential materials to which access is limited.

to approve a license transfer.¹¹ If FCC finds the public interest harm outweighs the public interest benefit of a transaction, it may enter into discussions with the merging parties, and ultimately, adopt conditions—that is, specific activities that the merged company would have to perform—that will change the balance of the public interest effects and thus enable the Commission to find the license transfers to be in the public interest.¹² Whatever FCC actions are taken in a particular case, interested parties (including, but not limited to, the merging companies) can file a lawsuit challenging FCC’s decision. Any party filing such a lawsuit against a Commission decision bears the burden of proof in showing that the decision was “arbitrary and capricious” or beyond the Commission’s authority.

State Attorneys General. State attorneys general also have the authority to block mergers under federal antitrust law.¹³ Because few mergers will affect only one state, the attorneys general have formed a task force through the National Association of Attorneys General to coordinate merger reviews by multiple attorneys general. Typically, one state will take the lead role to coordinate the merger review. Additionally, if the merging parties consent, filings submitted to DOJ are shared with participating state attorneys general for their review.¹⁴ The National Association of Attorneys General and DOJ have developed a protocol for how the state attorneys general and the Department will conduct a joint investigation on the antitrust implications of a proposed merger.

The National Association of Attorneys General has also developed merger guidelines—which have some similarities to DOJ’s merger guidelines—to analyze how a merger will affect competition. If a single state attorney general or a group of attorneys general determines that a merger will substantially harm competition—which is the standard for a merger to be illegal under the Clayton Act—a state or a combination of states can file an action in court to stop the merger. They can also file comments in hearings before state utility commissions or join in a proceeding with DOJ.

¹¹Prior to a final finding that it cannot find a merger to be in the public interest, the Commission will send the case for a hearing before an administrative law judge. If that judge also cannot find the merger to be in the public interest, the case goes back to FCC for a final ruling.

¹²According to FCC documents, the Commission has the authority to attach conditions to its approvals of license transfers under sections 214(c) and 303(r) of the Communications Act.

¹³In some cases, attorneys general may also challenge mergers under state antimerger laws.

¹⁴The Voluntary Pre-Merger Disclosure Compact, sponsored under the auspices of the National Association of Attorneys General, creates a contractual understanding between the compact’s signatory states and the parties concerning the sharing of information filed with DOJ and the coordination of the investigation by the state attorneys general. As part of the compact, participating states agree to refrain from filing subpoenas for additional information from the parties.

State Public Utility Commissions. State statutes that provide the authority to public utility commissions (sometimes called public service or commerce commissions) vary a great deal with regard to their merger review authority. According to a representative of the National Association of Regulatory Utility Commissioners, some state utility commissions have the authority to review mergers of the companies that they regulate, other state utility commissions have the authority to review only transfers of regulated companies' assets, and still others have no role at all in reviewing or approving mergers between telephone companies. While most commissions' reviews focus on whether mergers are in the public interest, some commissions also specifically examine competition issues.

Bell Atlantic-NYNEX Merger Went Forward With Conditions

According to the merging companies, Bell Atlantic and NYNEX merged to take advantage of a variety of expected benefits both within their local telephone markets and in markets that the firms hoped to enter (such as the long-distance market). The merger review process, which began in April 1996 when Bell Atlantic and NYNEX announced their intention to merge, was completed when the last of all federal and state governmental reviewing bodies approved the merger in August 1997. The review process was lengthy in part because of the complexity of the analyses conducted by these bodies. At the federal level, the merger was reviewed by DOJ under federal antitrust statutes and by FCC under the Communications Act of 1934. Five state utility commissions conducted formal merger review proceedings, and a task force of state attorneys general also reviewed the merger.¹⁵ Neither DOJ nor any of the state attorneys general sought to block the merger on the basis that it would violate antitrust laws. In addition, the merger was approved by FCC and the five state utility commissions that formally reviewed the merger. However, FCC and four of the states placed specific conditions on the merging parties, many of which were designed to help foster greater competition in the local telephone market. While Bell Atlantic officials told us that the company has realized significant cost savings since the merger, no other significant measurable market effects can be definitively attributed to the merger at this time.

¹⁵The merging companies filed notices of the planned merger with all 14 utility commissions in the jurisdictions in which the companies operated. However, license transfers took place only within the NYNEX states, and five of these state utility commissions issued formal orders approving the merger. One of the state utility commissions in the original Bell Atlantic region, the New Jersey Public Utility Commission, also issued an order approving the merger, although no control of licenses was transferred in the state. Massachusetts also issued an order, even though it had no specific statutory authority to review or approve mergers of telephone companies.

A Variety of Expected Benefits Motivated Bell Atlantic and NYNEX to Merge

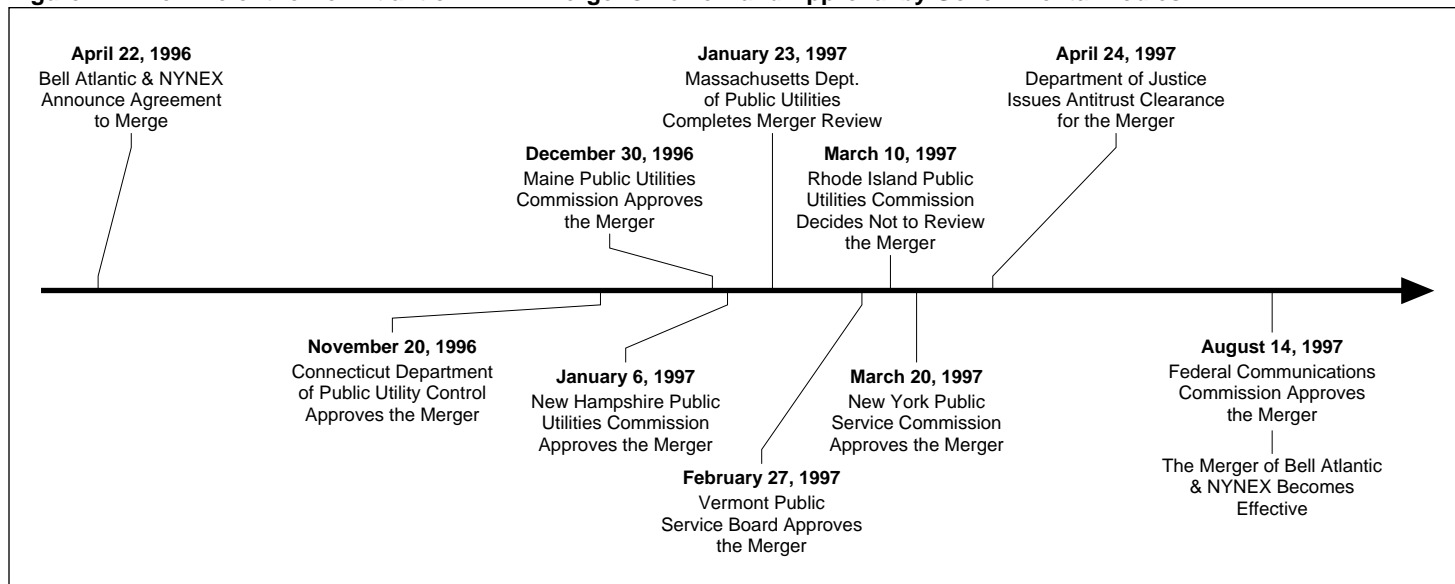
According to a Bell Atlantic official, the Bell Atlantic-NYNEX merger was intended to enable the unified company to compete more effectively in the delivery of local telephone service within the two companies' existing service areas. A Bell Atlantic official told us that the merger was expected to result in cost savings from the greater efficiencies gained by their combined operations.¹⁶ In addition, Bell Atlantic and NYNEX's merger application outlined the companies' plans to adopt each other's best practices to attain operational improvements. Cost savings and improved business procedures were considered by both companies to be necessary to retain their most valued customers in the face of new entrants into the local telephone market. In addition, Bell Atlantic stated in its merger applications that the merged company would be in a better position to enter the domestic long-distance market—which Bell Atlantic hoped to do soon after the merger's completion—as well as the global telecommunications market.

Bell Atlantic-NYNEX Merger Required Complex Competitive Analysis

Bell Atlantic and NYNEX announced their intention to merge on April 21, 1996, and the merger was finally completed on August 14, 1997. As figure 2 shows, over the course of those 16 months, various jurisdictions approved the merger. FCC officials told us that the merger review process was protracted partly because of the review's complexity. Besides the large size of the merging companies and the multiple reviewing bodies, the merger review was especially complicated because the merging parties were formerly monopolistic companies and because FCC's framework for applying its public interest standard was evolving as a result of the passage of the Telecommunications Act of 1996.

¹⁶Specifically, the anticipated cost savings resulted from greater economies of scale and scope. Economies of scale occur when larger production output is associated with lower per unit cost of production, and economies of scope occur when producing two or more similar products reduces the average costs of production of those products.

Figure 2: Time Line of the Bell Atlantic-NYNEX Merger's Review and Approval by Governmental Bodies



Note: The Bell Atlantic-NYNEX merger application was filed with FCC on July 2, 1996.

The history of Bell Atlantic and NYNEX as regulated monopolies, and the associated lack of a “market history,” made determining the competitive effects of this merger difficult. In most antitrust merger cases, companies’ previous market behaviors and strategies are central to the review, but such information in this case was less available and was of less use because both companies had been constrained in many ways by previous regulation. Despite the fact that these companies did not compete against each other, the competitive effects of their merger can be evaluated under the “actual potential competition doctrine” of DOJ’s merger guidelines. The actual potential competition doctrine focuses on whether, in the absence of the merger, one of the merging companies is likely to successfully enter the other’s market, and on whether competition in the market will be substantially lessened by the elimination of such entry. To show that a firm is a potential competitor, however, it is important to have evidence that the firm was actually planning or at least considered entering the market in question.¹⁷ The fact that a firm did not actually enter a market can make it difficult to prove that entry was likely. Additionally, while DOJ generally would not find that a merger between a

¹⁷Courts are split on the standard of evidence required to prove that a company was likely to enter a market.

current competitor and a potential competitor substantially lessened competition if at least three other viable competitors—current or potential—would remain after the merger, Department officials told us that in this case, the merger required careful scrutiny despite the existence of other potential competitors.

Officials at both DOJ and FCC told us that the actual potential competition standard was more difficult to apply to nearly monopolized markets where, until very recently, laws, regulations, and related requirements precluded the merging parties—in this case, Bell Atlantic and NYNEX—from entering each other’s market areas. Because of the complexity of applying the potential competition doctrine in what FCC called “transitional markets”—that is, markets that are in the process of changing from a regulated monopoly to a more competitive environment—the Commission developed a new framework: the “precluded competitor” analysis. FCC officials told us that the Commission developed this framework in order to protect the interest defined by the Communications Act. Under this framework, which is based on the same economic principles as those underlying antitrust doctrines, FCC could evaluate the likelihood that one of the merging parties (as well as others that had been precluded) would successfully enter markets where it had been precluded prior to the enactment and implementation of the procompetitive aspects of the 1996 Telecommunications Act. FCC’s framework characterizes some precluded competitors as “most-significant market participants.” In particular, Commission officials noted that a most-significant market participant would (1) have an incentive to enter a market from which it had been previously—but was no longer—precluded; (2) have the resources, experience, and ability to succeed in that market; and (3) would, upon entering, have a significant competitive impact in that market. Moreover, FCC stated that for precluded competitors that are most-significant market participants, the lack of actual entry or clear evidence of intent to enter a market should not be a decisive factor in evaluating a firm’s likelihood of entry because entry only recently became a possible market strategy for the firm. Thus, in contrast to the potential competition doctrine, harm to competition can be found from a merger between a current and a precluded competitor under FCC’s precluded competitor framework, even if little definitive evidence exists to show that the precluded competitor was about to enter the market.

In addition to the development of this new framework, FCC’s application of its public interest standard was also evolving in other ways during its

review of the Bell Atlantic-NYNEX merger. FCC officials told us that their merger analysis was incorporating the competitive focus of the Telecommunications Act of 1996. For example, in the order approving SBC's merger with Pacific Telesis, which occurred 11 months after the passage of the 1996 act, FCC stated that it was not necessary for the merging parties to demonstrate that, in the absence of any harms, this merger would create competitive benefits (see app. I). Seven months later in the Bell Atlantic-NYNEX order, however, FCC stated that any potential competitive harm related to a merger must be offset by competitive benefits so that the merger will be procompetitive and, therefore, in the public interest. Thus, FCC's application of the public interest standard focused more closely on competitive issues in the later merger. FCC officials confirmed to us that competitive issues within the public interest standard were more heavily weighted in the Commission's review of the Bell Atlantic-NYNEX merger, in part because of the focus of the 1996 act, in part because the specifics of the Bell Atlantic-NYNEX merger raised more competitive issues and in part because subsequent mergers among Regional Bell Operating Companies and/or other large incumbent local telephone companies will raise increasingly greater competitive concerns.

All Reviewing Bodies Allowed the Merger to Go Forward, but Some Imposed Conditions

The Bell Atlantic-NYNEX merger was not challenged in court by DOJ, the task force of state attorneys general, or any individual state attorneys general. DOJ officials told us that while evidence existed to suggest that Bell Atlantic had contemplated entering the market in the New York City metropolitan area, other information suggested that Bell Atlantic might not enter that market. Moreover, other potential entrants—such as the large long-distance companies—existed that also had the resources and ability to succeed in providing local telephone service in the New York market. Consequently, DOJ believed that there was too much uncertainty to determine that Bell Atlantic was uniquely situated to improve competition in this market. Although the task force of attorneys general had some concerns about the competitive effects of the merger, only the New York state attorney general, while not attempting to block the merger, formally stated opposition to the merger in a brief submitted to the New York Public Service Commission.

Using its newly derived precluded competitor framework, FCC concluded that Bell Atlantic was likely to enter the market for small business and residential telephone service in and around New York City and that Bell Atlantic was likely to be successful in that market. Thus, in FCC's view, the evidence showed that the merger would substantially retard or delay the

achievement of the Communication Act's competitive goals in the region. FCC noted that for the merger to be in the public interest, the potential harms of the merger would need to be outweighed by potential benefits. Bell Atlantic and NYNEX were able to demonstrate to the satisfaction of FCC that commitments made by Bell Atlantic in a letter to FCC on July 19, 1997 (and later modified on Aug. 13, 1997), were sufficient to outweigh any potential harm related to the merger. FCC's approval of the merger was conditioned on Bell Atlantic's meeting these commitments—now defined as conditions under the merger approval—throughout its entire service region. One of the conditions stated that all of the conditions would expire after 4 years.¹⁸

FCC's merger conditions included several items designed to promote greater competition in the provision of local telephone service and to achieve the goals of the Telecommunications Act of 1996. It appears that three of the conditions were most important to FCC's determination that the potential harms of the proposed Bell Atlantic-NYNEX merger would be outweighed by the expected benefits that would result from implementing the conditions. Under these three conditions, Bell Atlantic agreed to do the following:

- Provide uniform “interfaces” for obtaining access to the basic “operations system support” functions—such as placing an order, billing, and scheduling maintenance—which would help competing carriers efficiently access and purchase services from Bell Atlantic's network.
- Set the rates for “unbundled network elements”—piece parts of Bell Atlantic's network that competitors need to purchase in order to provide local service—based on “forward-looking economic costs.” An FCC official told us that under a forward-looking economic costing method, the prices of the unbundled network elements are based on the costs associated with the most efficient commercially available technologies, rather than on average historical costs of the telephone company's existing plant. Because technology has advanced so rapidly in this industry, the price of network elements based on forward-looking, rather than historical, costs will be lower.
- Provide detailed “performance monitoring reports” to FCC, state commissions, and competitive carriers. These reports provide data depicting the quality of service Bell Atlantic provides, both to competitive

¹⁸FCC provided for the Bell Atlantic-NYNEX Merger Conditions to sunset 48 months after the Commission approved the merger. In an FCC proceeding on Bell Atlantic's compliance with the merger conditions, a number of competitive carriers submitted comments arguing that because FCC intended the benefits of the conditions to last 4 years, the conditions should not sunset until 4 years after Bell Atlantic demonstrates full compliance. FCC officials told us that the sunset provision is among the matters currently being reviewed in this compliance proceeding.

carriers and to its own retail operations, thus conveying information on the network access Bell Atlantic affords to competing companies. These data could help detect any problems that may exist in Bell Atlantic's supply of unbundled network elements or bundled services to be resold by the competitors. In particular, these data could help determine whether Bell Atlantic is meeting its obligation to provide nondiscriminatory service to its competitors.

Five state utility commissions in the NYNEX region held formal proceedings and issued orders approving the Bell Atlantic-NYNEX merger. Four of these states imposed conditions on Bell Atlantic that pertained to Bell Atlantic's activities within their individual jurisdictions:

- The New York commission required that the new company establish its headquarters in New York City. The New York commission also required Bell Atlantic to (1) provide additional quality of service measurements; (2) hire an additional 750 to 1,000 employees by December 31, 1997, to address problems with service quality; and (3) improve service by making an additional \$1 billion investment in infrastructure improvements over the next 5 years.
- The Maine commission required that by September 30, 1997, Bell Atlantic meet the "competitive checklist" enacted as part of the Telecommunications Act of 1996.¹⁹ This checklist sets forth several requirements—such as allowing competitors to interconnect to the Bell network and to purchase unbundled network elements—that any Bell Operating Company must meet to be allowed to enter the long-distance telephone market. The state also required the merged company to maintain an investment in the state at a level similar to NYNEX's investment in recent years.
- Following Maine's lead, the Vermont commission required that Bell Atlantic meet the competitive checklist contained in the Telecommunications Act of 1996 by September 30, 1997. In addition, Vermont required so-called intrastate long-distance dialing parity, under which users would be able to dial the same number of digits regardless of whether they used Bell Atlantic or any other competitive provider for long-distance calls within the state of Vermont. The Vermont commission also required the merged company to maintain an investment level in the state equivalent to those of previous years.
- To ensure that service quality did not decline after the merger, the New Hampshire commission required Bell Atlantic to adopt the service standards of the National Association of Regulatory Utility Commissioners

¹⁹There are 14 points on the competitive checklist in section 271(c)(2)(B) of the Communications Act.

in the state. New Hampshire also required that the role of the key Bell Atlantic representative working in New Hampshire not significantly change or diminish after the merger and that the responsibility for construction, engineering, installation, and repair within the state rest with the company's representative assigned to the state rather than with Bell Atlantic executives elsewhere.

FCC opened a proceeding on February 5, 1999, on Bell Atlantic's progress in implementing FCC's merger conditions. In a report filed by Bell Atlantic in this proceeding²⁰ and in our discussions with company officials, Bell Atlantic stated that it has met FCC's merger conditions. However, some of the companies that compete with Bell Atlantic have filed complaints with FCC²¹ and have filed comments in this proceeding stating that Bell Atlantic has failed to meet some of the conditions. This disagreement appears to stem largely from varying interpretations of the meaning of specific language in FCC's merger order.

Bell Atlantic Realizes Cost Savings From the Merger, but Few Market Effects Are Identifiable

Bell Atlantic officials told us that the company has enjoyed considerable cost savings since the merger. The company originally estimated that the merger would achieve a cost savings of about \$850 million to \$900 million annually within 3 years, but company representatives told us that cost savings have surpassed that level. Beyond these cost savings, few effects can be directly attributed to the merger at this time, as illustrated by the following:

- Service quality in New York improved at about the time of the merger, but regulators attribute the improvement to the Performance Regulatory Plan that the state of New York had negotiated with NYNEX in 1995. Under the plan, NYNEX had agreed to pay substantial fines if it did not improve service quality in a number of areas. In Massachusetts, regulators noted that service had declined before the merger and had improved somewhat since that time. Massachusetts officials told us that the decline in service quality prior to the merger was most likely the result of a "reengineering" by NYNEX, which had led to excessive losses of knowledgeable service staff. The increase in quality at about the time of the merger was likely related to

²⁰An FCC official told us 15 comments were filed in this proceeding.

²¹Four complaints filed with FCC by two companies (one of which was filed jointly by the two companies) assert that Bell Atlantic has not complied with the merger conditions. The Commission is currently considering all of these complaints.

restaffing. In many of the other Bell Atlantic and NYNEX states, state regulators said they could not identify changes in service quality.²²

- Some state officials also told us that it is difficult to determine whether the prices that consumers are paying for local telephone service have been affected in any way by the merger. For example, some states pointed to some recent decreases in the prices of local telephone service, but attributed those changes to price cap regulations adopted in several states.
- While Bell Atlantic officials told us that the company has increased employment and investment levels since the merger, these changes are also difficult to attribute solely to the merger. Two state regulators also expressed concern that Bell Atlantic would redirect its capital investment away from smaller states to the larger states that were more likely to see the entry of new competitors. There is no evidence, however, that Bell Atlantic has undertaken such a strategy.

Agency Comments

We provided a draft of this report to the Federal Communications Commission and the Department of Justice for review and comment. FCC stated that the staff who reviewed the report were in general agreement with its conclusions (see app. II). FCC staff also provided us with technical comments, which we incorporated as appropriate. The Department of Justice provided some technical comments (see app. III), which we have addressed. We also provided excerpts of the draft to Bell Atlantic and SBC Communications officials. Both companies provided some corrections and modifications, which we incorporated as appropriate.

Scope and Methodology

To obtain information on the merger review process for telephone companies, we reviewed the relevant legislation, current federal and state merger guidelines, and federal and state orders approving the mergers of Bell Atlantic and NYNEX and of other telephone companies. We also interviewed officials at FCC, DOJ, the office of the New York Attorney General, the National Association of Attorneys General, and all the state public utility commissions in the Bell Atlantic and NYNEX states.

To obtain information on how the merger review process was applied in the Bell Atlantic-NYNEX merger and the extent of measurable effects of the merger to date, we reviewed Bell Atlantic's merger application and FCC's order approving the merger. We also examined state utility commission orders regarding the merger. We interviewed officials at FCC, DOJ, the

²²Two states' officials told us that since the merger, Bell Atlantic has been less responsive to state regulators than the premerger companies were. The view of these and some other state officials was that decision-making authority was being concentrated at Bell Atlantic headquarters in New York City.

Office of the New York State Attorney General, the National Association of Attorneys General, and the 14 public utility commissions in the Bell Atlantic and NYNEX service territories. We reviewed documents related to Bell Atlantic's compliance with FCC's merger conditions, including complaints filed by competitors with FCC alleging noncompliance. Finally, we interviewed officials at Bell Atlantic and at two national companies that have begun to compete in the local telephone market.

We conducted our review from December 1998 through August 1999 in accordance with generally accepted government auditing standards.

As agreed with your offices, unless you publicly release its contents earlier, we plan no further distribution of this report until 14 days after the date of this letter. At that time, we will provide copies to William E. Kennard, Chairman, Federal Communications Commission; Joel Klein, Assistant Attorney General, Antitrust, the Department of Justice; and other interested parties. We will also make copies available to others on request.

If you or your staffs have any questions about this report, please contact me at (202) 512-7631. Key contributors to this report are listed in appendix IV.



Judy A. England-Joseph
Director, Telecommunications Issues

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Abbreviations

AT&T	American Telephone & Telegraph
DOJ	Department of Justice
FCC	Federal Communications Commission
FTC	Federal Trade Commission
SNET	Southern New England Telephone

SBC's Acquisitions of Pacific Telesis Group and Southern New England Telephone

In addition to the Bell Atlantic-NYNEX merger, two other large local telephone company mergers have occurred since the Telecommunications Act of 1996 was passed. In April 1997, SBC Communications Inc., the parent company of Southwestern Bell Telephone Company, which provides local telephone service in Arkansas, Kansas, Missouri, Oklahoma, and Texas, acquired Pacific Telesis Group (PacTel), which provided local and wireless service through Pacific Bell and Nevada Bell in substantial parts of California and Nevada (see fig. 1). SBC and PacTel were two of the smallest Baby Bells.²³ In addition, in October 1998, SBC acquired Southern New England Telephone (SNET), an independent telephone company, far smaller than the Baby Bells, that provides local, wireless and long-distance telephone services in Connecticut.

SBC officials described the acquisitions of PacTel and SNET as a response to increasing and changing customer demands for telecommunications services (particularly business customers with multistate operations) and said that through these mergers, SBC hoped to better serve its customers, become a more effective competitor, and enhance its potential to compete in other domestic and international markets. SBC officials told us that the acquisition of PacTel was also motivated by the ending of its local telephone franchise and the opening of the local market, with the enactment of the 1996 act and by the inroads being made by competitive providers in large and medium-sized cities in SBC's service areas. In addition, SBC's and PacTel's management teams were concerned about improving their companies' earnings to satisfy shareholders and the investment community at a time when growth in their local telephone market shares was expected to be static. Like the Bell Atlantic-NYNEX merger, the SBC-PacTel merger was viewed by officials of the companies as providing new and improved services, cost savings from increased economies of scale and scope, and the application of best practices across the combined company.

The acquisition of SNET by SBC was also viewed as a means to grow SBC's local telephone business and, for SNET, to improve its attractiveness to investors in a changing local telephone market. Because SBC was already providing cellular telephone services in New England, the acquisition of SNET was viewed as complementing SBC's existing business and as enabling the company to better compete in other areas of the northeast region.

²³According to 1995 and 1996 data from the Federal Communications Commission, SBC and PacTel were among the smallest of the Baby Bells in terms of number of employees, revenues, and customer lines.

The federal and state reviews of SBC's acquisitions of PacTel and SNET appear to have been similar to those described in the Bell Atlantic-NYNEX case. These acquisitions, like the Bell Atlantic-NYNEX merger, were reviewed by the Federal Communications Commission (FCC) and the Department of Justice (DOJ) and by all of the public utility commissions and attorneys general in the relevant states in which the transfer of licenses would occur.

The SBC-PacTel merger was approved by all relevant federal and state governmental bodies. At the federal level, the merger was not challenged under the federal antitrust laws by DOJ. FCC issued an order approving the transfer of licenses from PacTel to SBC on January 31, 1997, 9 months after the companies announced their intention to merge. The Commission did not need to apply formally the standard that it used later in its August 1997 order approving the Bell Atlantic-NYNEX merger: that the benefits of the merger must, on balance, outweigh the potential harm. Instead, FCC concluded that the SBC-PacTel merger would not lead to a reduction of competition and that it might result in some modest improvements to the competitiveness and performance of some markets; hence, there was no need to engage in a balancing process.²⁴

At the state level, the California Attorney General issued an advisory opinion after review stating that the SBC-PacTel merger would not adversely affect competition. However, to ensure approval of the merger, SBC made certain commitments to both the California and Nevada state commissions. In December 1996, the Nevada Public Service Commission approved the merger. However, the Nevada commission required SBC to provide at least \$4 million in credits to Nevada Bell customers, in part, because SBC had offered to provide credits to California customers and had made a promise to establish four new headquarters in California. In an order issued in March 1997, the California commission concluded that the merger would benefit shareholders, the financial condition and management of PacTel, and the California economy and was unlikely to adversely affect competition. However, the California commission imposed conditions requiring SBC to provide credits to ratepayers of more than \$200 million over 5 years to reflect the short- and long-term economic benefits of the merger; implement a 10-year program to fund \$50 million in consumer education efforts and \$32 million for other activities to ensure service to underserved communities; show compliance with certain service quality standards; and, in the event that SBC proposed to acquire

²⁴FCC's order approving the SBC-PacTel merger states that a demonstration that benefits will arise from the merger is not a prerequisite for approval, provided that no foreseeable adverse consequences will result.

another local telephone company within 5 years after the merger, to notify the commission and explain how it would affect the SBC-PacTel merger and the company's response to the state's imposed conditions.

SBC's acquisition of SNET was also approved by all relevant federal and state reviewing authorities. The acquisition was not challenged as a violation of antitrust laws by either DOJ or Connecticut's Attorney General.²⁵ The Connecticut Department of Public Utility Control approved the merger and accepted a set of commitments by SBC that included maintaining SNET's headquarters in Connecticut, continuing SNET's charitable contributions and contributing \$1 million to institutions of higher learning in the state, conducting a trial of high-speed data service over SNET's existing infrastructure, and planning operations support systems to be used by competitors to order facilities and services. The department also conditioned its approval on SBC's continued compliance with the terms and conditions of SNET's cable television subsidiary for 2 years. The SBC-SNET merger was reviewed by FCC under the framework first developed in the Bell Atlantic-NYNEX merger review. FCC found that SBC's acquisition of SNET was not likely to harm the public interest and was likely to produce some tangible benefits.²⁶ Among other conditions for approval, FCC required the companies to complete and continue fulfilling measures designed to ensure the merger does not result in SBC providing long-distance services in its region in violation of the Communications Act and to continue the restructuring of local telephone operations in Connecticut in accordance with requirements of the state commission.²⁷

According to SBC, since the merger of SBC-PacTel closed in April 1997, approximately 4,500 new jobs have been created in California as of June 1999, including positions for technicians to build network facilities and install and maintain telephone lines and for service representatives. SBC also claims that the total capital budget for Pacific Bell, PacTel's local

²⁵The Connecticut Office of the Attorney General did raise concerns in the proceeding of the Connecticut Department of Public Utility Control on the merger regarding SBC's marketing practices in California and the suitability of SBC as the owner of SNET's statewide cable television subsidiary.

²⁶In its order approving the merger, FCC described its duty to weigh the potential harm to the public interest against the potential benefits to ensure that, on balance, the merger served the public interest, which, at a minimum, requires that it does not interfere with the objectives of the Communications Act.

²⁷Upon closing an investigation into whether, after the merger with SNET, SBC may have been in violation of the law in the provision of long-distance information services (secs. 271-272 of the Communications Act) and related FCC regulations, FCC entered into a consent decree with SBC in June 1999 to ensure future compliance. Although no wrongdoing was admitted by SBC, the company agreed to change its internal operations to ensure compliance and to make a voluntary \$1.3 million payment to the U.S. Treasury.

Appendix I
SBC's Acquisitions of Pacific Telesis Group
and Southern New England Telephone

telephone subsidiary in California, has increased 11 percent since the merger closed, with 20 percent more being spent to expand the Pacific Bell network, improve service quality, and make new lines available to consumers. Service orders for telephone installations are processed more quickly, customer trouble reports have declined, and the speed of repairs for service disruptions has accelerated. Finally, SBC states that the price of Pacific Bell's basic local telephone service has not changed since the completion of the merger.

Comments From the Federal Communications Commission

FEDERAL COMMUNICATIONS COMMISSION
Washington, D. C. 20554

OFFICE OF
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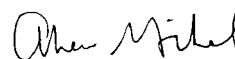
August 6, 1999

Ms. Judy England-Joseph
Director, Telecommunications Issues
Resources, Community, and Economic
Development Division
U.S. General Accounting Office
Washington, DC 20548

Dear Ms. England-Joseph:

Thank you for the opportunity to review and comment on the General Accounting Office's draft report entitled "Telecommunications: Process by Which Mergers of Local Telephone Companies are Reviewed." It has been reviewed by the Common Carrier Bureau. Bureau staff is in general agreement with the conclusions reached therein and has provided you, under separate cover, some comments. We have no additional concerns with the report.

Sincerely,



Andrew S. Fishel
Managing Director

Comments From the Department of Justice

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



U.S. Department of Justice

Antitrust Division

*Patrick Henry Building
601 D Street, NW
Washington, DC 20530*

July 29, 1999

Ms. Judy England-Joseph
Director, Telecommunications Issues
Resources, Community and
Economic Development Division
U.S. General Accounting Office
Washington, DC 20548

Dear Ms. England-Joseph:

This letter responds to the GAO Draft Report, "Process by Which Mergers of Local Telephone Companies Are Reviewed," which was sent to the Department of Justice on July 15, 1999 for review and comment.

The Draft Report contains two statements which we believe may convey an incorrect understanding of the Justice Department's review of mergers of local telephone companies. First, on page 11, the Draft Report states that "[t]he actual potential competition doctrine focuses on whether, in the absence of the merger, one of the merging companies is likely to successfully enter the other's market and thereby enhance competition. If so, then the merger can be found anticompetitive since it denies the market this enhanced competition through entry." This statement might be understood to indicate that a violation of Section 7 of the Clayton Act is established whenever a merger eliminates a potential competitor from a market. However, Section 7 does not prohibit all mergers that result in the elimination of a competitor. Rather, in order to demonstrate a violation of Section 7, the Department must prove not only that the merger will eliminate an independent competitor, but also that the elimination of that competitor (whether an "actual" competitor or a "potential" competitor) will result in a substantial lessening of competition in the relevant market. The Draft Report's discussion of this issue, we believe, would be clearer if the first sentence quoted above is revised to read as follows: "The actual potential competition doctrine focuses on whether, in the absence of the merger, one of the merging companies is likely to successfully enter the other's market, and on whether competition in the market will be substantially lessened by the elimination of such entry."

Second, on page 13, the Draft Report states that in reviewing the Bell Atlantic/Nynex merger, the FCC "concluded that Bell Atlantic was likely to enter the small business and residential telephone service markets in and around New York City -- a different conclusion from that of DOJ . . ." It is incorrect to suggest that DOJ reached a different conclusion on this issue than did the FCC. DOJ concluded that it was "appropriate to regard Bell Atlantic as one of a few likely significant entrants" into the New York City market. Letter from Constance K. Robinson, Director of Operations & Merger Enforcement, to Nancy Barry, U.S. General Accounting Office

Now on p. 12.

See comment 1.

Now on p. 14.

See comment 2.

GAO Comments

1. We made the Department of Justice's suggested wording change.
2. We deleted the phrase "a different conclusion from that of DOJ."

GAO Contacts and Staff Acknowledgments

GAO Contacts

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Acknowledgments

In addition to those named above, Dennis Amari, Nancy Barry, Thomas Farrell, Fran Featherston, and Mindi Weisenbloom made key contributions to this report.

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