

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

EARTHLINK, INC.)	
)	
Complainant,)	
)	
v.)	File No. _____
)	
SBC COMMUNICATIONS INC.,)	
SBC ADVANCED SOLUTIONS, INC.)	
)	
)	
Defendants.)	

DECLARATION OF ROBERT W. CRANDALL AND HAL J. SINGER

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QUALIFICATIONS

1. Our professional qualifications for submitting this expert report are as follows.
2. My name is Robert W. Crandall. I am the chairman of Criterion Economics and Senior Fellow in Economic Studies at the Brookings Institution in Washington, a position that I have held since 1978.
3. My name is Hal J. Singer. I am co-founder and President of Criterion Economics.
4. We file this declaration in our individual capacities and not on behalf of the Brookings Institution, which does not take institutional positions with respect to specific legislation, litigation, or regulatory proceedings. Our extended biographies were included in our original declaration.

INTRODUCTION AND SUMMARY OF CONCLUSIONS

5. We have been asked by SBC Communications Inc. (SBC) to respond to the reply comments by EarthLink in this proceeding. In particular, we have been asked to comment on Dr. Ankum's Reply Affidavit,¹ EarthLink's Reply,² and EarthLink's Discovery Response.³ These replies were intended to bolster EarthLink's original claims that SBC engaged in unlawful cross-subsidization and discrimination by (1) allegedly setting its monthly rate for broadband transport roughly \$12 *above* its stand-alone cost of providing wholesale service,⁴ and (2) allegedly setting

1. Reply Affidavit of Dr. August H. Ankum on behalf of EarthLink, Inc. (filed July 12, 2004) [hereinafter *Ankum Reply*].

2. EarthLink's Reply (filed July 12, 2004) [hereinafter *Reply*].

3. EarthLink's Corrected Response to Defendants' First Request for Interrogatories (filed Oct. 4, 2004) [hereinafter *Discovery Response*].

4. EarthLink Complaint, Counts I & II at 4 ¶ 7 (filed May 13, 2004) [hereinafter *Complaint*].

its monthly rate for broadband Internet access between \$6.80 and \$15.64 *below* its incremental cost of providing DSL service to end users.⁵ Even if accurate, EarthLink’s claims, including its latest evidence, do not establish cross-subsidy or discrimination as a matter of economic theory or practice.

6. In Part I, we explain why EarthLink has failed to demonstrate that SBC engaged in a cross-subsidy or discrimination as an economic matter. EarthLink applies one irrelevant test (the stand-alone cost test) for analyzing whether a cross-subsidy exists. And with respect to the relevant test it uses (the incremental cost test), it applies it incorrectly. EarthLink’s cross-subsidy theory also does not make sense because it does not involve two separate services. However, even if DSL transport were considered a separate service from retail DSL Internet access service, SBC could not recover any supposed subsidy provided to its retail customers by charging wholesale customers inflated rates. Moreover, EarthLink fails to appreciate how market forces—including intense competition from cable modem providers—discipline both SBC’s pricing of wholesale DSL transport and retail DSL Internet access service. In Part II, we demonstrate that even if there were a cross-subsidy or discrimination, EarthLink cannot prove it would harm consumers. EarthLink fails to provide a coherent theory of consumer harm and improperly ignores competition in the broadband Internet access services. In Part III, we explain why regulating the price of DSL transport *and* DSL Internet access service for end users, which is the remedy that EarthLink really seeks, would harm consumers.

5. *Id.* at 13 ¶ 21. The February 2004 estimate is equal to the difference between the “break-even margin” of \$15.59 and the actual retail margin of \$8.79. The June 2003 estimate is equal to the difference between the “break-even margin” of \$15.59 and the actual retail margin of -\$0.05.

I. EARTHLINK HAS FAILED TO DEMONSTRATE THAT SBC ENGAGED IN CROSS-SUBSIDY AS AN ECONOMIC MATTER

7. EarthLink alleges that SBC's retail price of DSL Internet access is less than SBC's incremental cost of providing DSL Internet access service to end users. But EarthLink has not calculated the incremental cost of the relevant SBC services correctly, has not proved the existence of a separate market for DSL transport, and fails to understand how market forces constrain SBC's pricing of DSL transport and retail DSL Internet access service. EarthLink would have to demonstrate all three of these conditions to support its claim.

A. EarthLink Has Not Satisfied the Necessary Conditions for Cross-Subsidization

8. In an attempt to resuscitate its claim that SBC engaged in a cross-subsidy, EarthLink and its witness cite an unpublished manuscript by Professor Gerald Faulhaber.⁶ The manuscript describes two tests to establish the absence of cross-subsidy: (1) the incremental cost test and (2) the stand-alone cost test. To satisfy the incremental cost test, incremental revenues from a service or a combination of services must *exceed* the incremental costs of that service or combination of those services. To satisfy the stand-alone cost test, incremental revenues from a service or a combination of services must be *equal to or less than* the stand-alone costs of that service or combination of those services. These tests are typically applied to a regulated firm whose total revenues are controlled by a "revenue requirement."

9. Because the services in this proceeding are not subject to a binding regulatory constraint in which total revenues are equal to total costs, the relevant test—to the extent that cross-subsidy is even the appropriate claim—is the incremental cost test. Stated differently, because the sum of the revenues from SBC's retail DSL services and its wholesale DSL transport

6. *EarthLink Reply* at 44 ¶ 46 (citing Gerald R. Faulhaber, *Cross Subsidy Analysis with More Than Two Services*, unpublished manuscript, Aug. 11, 2002 [hereinafter *Faulhaber Unpublished Manuscript*]).

services are not constrained by an overall regulatory revenue requirement, it is possible for incremental revenues from a service to exceed the stand-alone costs of that service without cross-subsidy. Hence, the stand-alone cost test is not applicable in this case.

10. Ignoring this somewhat critical point, EarthLink goes on to incorrectly apply the stand-alone cost test.⁷ In particular, EarthLink fails to apply that test correctly because it fails to understand that SBC would need to replicate a large portion of its local telephone network—and therefore incur a large portion of its network costs that are not included in EarthLink’s calculation—if it were to offer DSL transport in isolation. Nowhere does Earthlink provide evidence that SBC’s DSL service—either at the wholesale level, retail level, or both levels together—generates revenues that are in excess of its total network stand-alone costs.

11. When it finally considers the appropriate incremental-cost test, EarthLink likewise fails to apply that test correctly by confusing SBC’s incremental *cost* of DSL transport with SBC’s *price* of wholesale DSL transport. Professor Faulhaber defines the incremental cost of providing a given service as the stand-alone cost of providing all services less the stand-alone cost of providing all services save the service in question.⁸ For simplicity, assume that SBC offers local telephone service, wholesale DSL transport, and retail DSL service only. To estimate SBC’s incremental cost of wholesale DSL transport or retail DSL service, it is necessary to estimate SBC’s stand-alone cost of providing local telephone service, wholesale DSL service, and retail DSL service, *as there are shared costs in providing those services in combination*. Applied here, the incremental cost of wholesale DSL transport would be as follows:

7. *Id.* at 48 ¶ 52.

8. *Faulhaber Unpublished Manuscript* at 1.

[1] *Incremental cost of wholesale DSL transport = Stand-alone cost of local telephone and DSL transport less the Stand-alone cost of local telephone service.*

Likewise, the incremental cost of providing retail DSL service would be as follows:

[2] *Incremental cost of retailing the DSL service = Stand-alone cost of local telephone, DSL transport, and retail DSL service less the Stand-alone cost of local telephone service and DSL transport.*

Finally, the incremental cost of offering retail DSL service is equal to the stand-alone cost of offering all three services less the stand-alone cost of local telephone service, as retail DSL is a combination of DSL transport and retailing the DSL service. If there are no joint costs in the production of DSL transport and retailing the DSL service, then the incremental cost of offering retail DSL service is equal to the sum of [1] and [2].

12. Table 1 lists descriptions of the relevant pricing and cost data that would inform the traditional cross-subsidy analysis applied to this proceeding. The cells in Table 1 have been populated with EarthLink’s (incorrect) estimates of the relevant revenues and costs. The incremental-cost test for subsidy-free pricing would be violated if, for any row, the value in column one (when properly estimated) were less than the value in column three (when properly estimated).

TABLE 1: SUBSIDY-FREE PRICING ACCORDING TO FAULHABER’S UNPUBLISHED MANUSCRIPT

Services	EarthLink’s Estimate of SBC’s Price	EarthLink’s Estimate of SBC’s Stand-alone Cost	EarthLink’s Estimate of SBC’s Incremental Cost
Local telephone (1)	NA	NA	NA
Wholesale DSL transport (2)	\$23.00	\$10.99	NA*
Retail DSL (3)	\$28.79	NA	\$38.59 (\$23.00 + \$15.59)
Local telephone & wholesale DSL transport (1 & 2)	NA	NA	NA
Local telephone & retail DSL (1 & 3)	NA	NA	NA
Wholesale DSL transport & retail DSL (2 & 3)	NA	NA	NA
Local telephone, wholesale DSL transport, and retail DSL (1, 2 & 3)	NA	NA	NA

Note: NA denotes that the item was not produced by the plaintiff. * EarthLink assumes SBC’s incremental cost of DSL transport is equal to SBC’s price of DSL transport.

As Table 1 shows, for six of seven incremental cost categories, EarthLink has not offered *any* data. (Where it does offer data, EarthLink's estimates of incremental retail DSL service costs appear to be exaggerated, particularly with respect to customer support, which it estimates to be \$5.58 per subscriber per month.)

13. The failings of EarthLink's argument go far beyond its failure to present relevant data. Rather than following Faulhaber's approach, EarthLink incorrectly adds SBC's *price* of DSL transport (EarthLink's proxy for SBC's incremental cost of DSL transport) to EarthLink's estimate of SBC's average variable retail costs (EarthLink's proxy for SBC's incremental cost of retail DSL service).⁹ But SBC's *price* for DSL transport is not relevant to the calculation of SBC's incremental cost of providing DSL transport per equation [1]. Price may bear some relationship to average variable costs, but incremental costs are lower than average variable cost whenever there are large fixed costs, such as product and software development and network plant, as is the case here.

14. In general, the cross-subsidy analysis should not be concerned with whether EarthLink can earn a sufficient margin to cover its own costs: the issue is whether SBC is pricing its retail DSL service below *its own* incremental cost of providing retail DSL service. Because EarthLink has miscalculated SBC's incremental cost of providing retail DSL service, EarthLink concludes incorrectly that the incremental cost test is violated.

9. Affidavit of Dr. August H. Ankum on behalf of EarthLink, Inc. at 14 ¶ 26 (filed July 12, 2004) [hereinafter *Ankum Aff.*]

B. EarthLink’s Cross-Subsidy Theory Does Not Make Sense Because It Does Not Involve Two Separate Services

15. As we explained in our original declaration,¹⁰ SBC’s pricing of wholesale broadband transport and retail broadband Internet access does not involve a cross-subsidy, as that practice is understood by economists. Cross-subsidy describes the pricing by a *multi-product* firm of one product below the incremental costs of providing that product and using the proceeds from selling a *second product* to make up the resulting deficit.¹¹ Thus, two separate product markets are needed for cross-subsidy to be possible. When a firm sells a product as well as inputs to that product, the joint pricing of that product and its inputs could potentially reflect a “price squeeze,” but not a cross-subsidy. Because there are not two separate products purchased by the end user in this case, what EarthLink alleges is really a prices squeeze, although it does not call it that.

16. SBC’s DSL transport is simply an input into a single product—high speed Internet access—sold to a single consumer. Because SBC’s customers pay a single price for DSL service (as opposed to one price for transport and a second price for DSL service), SBC obviously cannot recoup its alleged retail subsidy by charging end users a higher price for transport. Nor can it recoup its alleged retail “subsidy,” which results from reducing its retail prices in response to competition, by raising the price of wholesale transport, which is being purchased by resellers who compete with retail DSL services and cable modem services. If SBC

10. *Crandall-Singer Decl.* at 9 ¶ 20.

11. *See, e.g.,* Gerarld R. Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, 65 AM. ECON. REV. 966 (1975) (“If the provision of any commodity (or group of commodities) by a multicommodity enterprise subject to a profit constraint leads to prices for the other commodities no higher than they would pay for themselves, then the price structure is *subsidy-free*.”) (emphasis in original); *see also* WILLIAM J. BAUMOL & ALAN S. BLINDER, *MICROECONOMICS: PRINCIPLES AND POLICY* 440 (7th ed. Dryden Press 1997) (“The price ceiling [this is the ceiling, and the subsidized product is below the floor] should be the cost that a *hypothetical* (that is, imaginary) efficient entrant would have to bear to supply each *specific* service.”).

inflated the price of transport while reducing the price of its retail DSL service, then competitors would presumably be unable to compete at the retail level using the wholesale input, and there would be no demand for the wholesale service. Because the incremental cost of the DSL transport service is less than the average cost, eliminating demand for the transport service would reduce the amount of DSL service sold and thus increase SBC's per unit costs for its retail (and wholesale) service. Therefore, EarthLink's suggestion that SBC is subsidizing its retail DSL service with increased margins from the sale of DSL transport is nonsensical.

C. Competitive Forces Discipline SBC's Pricing of DSL Transport

17. EarthLink argues incorrectly that an increase in the price of SBC's "DSL transport brings in additional dollars to the corporate parent (through ASI) which are not offset by any corresponding loss."¹² Because SBC faces competition from cable modem and other platform providers, however, SBC would prefer that more efficient Internet retailers take its wholesale offering if the alternative were the loss of the customer entirely to a cable modem provider or some other alternative broadband provider. In that way, SBC gets at least some revenue. An increase in the DSL transport price above the profit-maximizing access price¹³ is offset by a subtle "corresponding loss," which EarthLink fails to detect. Competition at the end user level thus determines SBC's pricing of DSL transport—higher retail margins allow for a higher wholesale rate (to compensate SBC for its foregone margins when it loses the customer to a reseller) while smaller retail margins promote a lower wholesale rate.

12. EarthLink Reply at ¶ 65.

13. The profit-maximizing access rate would begin with the retail price for DSL service less the avoided retail cost, but would also include the incremental value that SBC receives by retaining the customer (for example, the access line or ancillary services).

18. Indeed, the FCC has already accepted this logic in its recent decision to forbear from imposing unbundling obligations for certain broadband elements under Section 271.¹⁴ The agency noted that inter-modal competition would spur carriers to enter into voluntary access agreements:

With regard to the potential impact of forbearance specifically on the wholesale broadband market, as raised by certain competitive LEC commenters, the evidence currently before us, taken as a whole, leads us to conclude that competition from multiple sources and technologies in the retail broadband market, most notably from cable modem broadband providers, will pressure the BOCs to utilize wholesale customers to grow their share of the broadband markets and thus the BOCs will offer such customers reasonable rates and terms in order to retain their business. Verizon plausibly claims that because the BOCs face intense intermodal competition, even in the absence of section 271 unbundling they will need to find ways to keep traffic “on-net,” which we conclude would likely include the provision of wholesale offerings.¹⁵

The FCC recognized how competitive forces discipline the availability and pricing of DSL transport.

II. EVEN IF THERE WERE A CROSS-SUBSIDY OR DISCRIMINATION, EARTHLINK CANNOT PROVE IT WOULD HARM CONSUMERS

19. The conditions for consumer harm are not satisfied in this case, regardless of whether wholesale DSL transport is viewed as part of the same product market as retail DSL service or as part of a different market. EarthLink apparently has ignored or misunderstood the major theme of our report.

14. Opinion and Order In the Matters of Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. Section 160(c), SBC Communications Inc.’s Petition for Forbearance Pursuant to 47 U.S.C. Section 160(c), Qwest Communications International Inc. Petition for Forbearance Pursuant to 47 U.S.C. Section 160(c), BellSouth Telecommunications, Inc. Petition for Forbearance Pursuant to 47 U.S.C. Section 160(c), WC Dkt. Nos. 01-338, 03-235, 03-260, and 04-48, Oct. 22, 2004 [hereinafter *Forbearance Order*].

15. *Id.* at 13-14 ¶ 26.

A. EarthLink's Discovery Response Regarding Its Use of Alternative Broadband Transport Providers Supports the Conclusion That the Broadband Internet Services Marketplace Is Competitive

20. In its *Reply*, EarthLink claims that it does not have marketplace alternatives to DSL transport from SBC.¹⁶ In its *Discovery Response*, by contrast, EarthLink acknowledged that it has entered into access arrangements with operators that offer cable modem, satellite, and Wi-Fi service.¹⁷ As of April 15, 2004, EarthLink acknowledged that it served 8,400 end users over Comcast's cable modem network, 435,200 end users over Time Warner's cable modem network (including the networks of its subsidiaries), 13,900 end users over DirecTV's satellite broadband network, and 1,200 end users over Boingo Wireless's Wi-Fi network.¹⁸ It serves more than 185,000 end-users over Covad or other alternative providers' DSL facilities, which exceeds the 132,300 end users it serves over ILEC provisioned DSL facilities. EarthLink also acknowledged that it has had an arrangement with Digital Path Networks for the purchase of wireless broadband transport.¹⁹ Hence, it is not credible for EarthLink to claim that it lacks marketplace alternatives to DSL transport.

21. EarthLink fails to demonstrate why non-DSL Internet access providers that opt not to offer a wholesale product to unaffiliated companies should not be considered as part of the relevant product market. Regardless of whether a particular cable modem operator in a particular geographic market offers a wholesale product to resellers, so long as that carrier services end users it must be considered part of relevant product market. The presence of cable modem

16. *EarthLink Reply* at 28 ¶ 30.

17. Complainant's Answers to Defendants' First Request for Interrogatories, Sept. 24, 2004, at 3.

18. *Id.* at 3-4.

19. *Id.* at 4.

providers *alone* is sufficient to constrain SBC in its pricing of DSL Internet access for end users, and as we explained above, even constrains SBC in its pricing of DSL transport.

22. Lacking any other reason to exclude cable modem providers from the relevant market, EarthLink turns to the issue of whether fixed wireless and satellite providers should be included in the market. In particular, EarthLink argues incorrectly that fixed wireless and satellite providers “hold insufficient market share (just 1.3%) to be considered serious competition to SBC in any relevant market.”²⁰ But availability of those alternatives—not their use—is the key to whether a service provider should be included in the market, and that is certainly true with respect to cable modem and satellite service providers. To the extent that use is relevant, for these technologies to be part of the same product market as SBC’s broadband network, only a small or “critical” share of SBC’s broadband customers would have to substitute to these alternatives in response to a small price increase by SBC.²¹ If a sufficient number of SBC’s customers switch to wireless or fixed satellite providers in response to a price increase, then such a price increase is rendered unprofitable and the scope of the product market would have to be expanded to include fixed wireless and satellite services. The critical share depends on the own-price elasticity of demand facing SBC its profit margin. It is not necessary, as EarthLink seems to believe, that the vast majority of SBC’s customers must consider satellite and fixed wireless services to be perfect substitutes to SBC’s DSL offering.²²

20. *EarthLink Reply* at 33 ¶ 36.

21. *See, e.g.,* Jerry A. Hausman & J. Gregory Sidak, *A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks*, 109 *YALE L.J.* 417, 477-79 (1999).

22. As we explain below, even in the handful of geographic markets where DSL does not compete against a single broadband provider, SBC cannot exercise market power due to its regional-wide pricing plans.

B. Cross-Subsidy Raises No Issue of Consumer Harm in the Absence of a Threat of Market Power in the Subsidized Market

23. EarthLink argues incorrectly that “the state of competition is irrelevant when performing the legal test for cross-subsidy.”²³ But EarthLink seeks more than proof of cross-subsidy—it seeks regulatory intervention to prevent SBC from charging low, market-based retail DSL prices. From an economic perspective, regulatory intervention is not warranted unless consumer harm is threatened.²⁴ And the threat of consumer harm depends on the state of competition in the relevant market.

24. If the only victims from lower retail DSL Internet access prices were unaffiliated DSL resellers, then there should be no reason to prevent the RBOCs from charging low retail DSL Internet access prices. Consumer harm requires an *increase* in price, not a *decrease*. SBC’s price reduction could only hurt consumers if SBC could raise prices sufficiently in future periods to more than offset the consumer *benefits* (and any losses SBC incurs) in the short run. Such future increases could occur only if all other material sources of competition had been driven from the marketplace. But the likelihood of higher *future* prices depends on, among other things such as barriers to entry, the current degree of competition and the longevity of SBC’s rivals—the very factors that EarthLink implores the FCC to ignore. Because SBC could not drive cable companies out of the broadband business and subsequently recoup its losses from “subsidizing”

23. *EarthLink Reply* at 3 ¶ 5.

24. *See, e.g.*, In Economic Forum: Antitrust and Economic Issues (July 23, 1996) (available at <http://www.fcc.gov/pub/Bureaus/Wireless/OPP/economics.trans.txt>). In the summer of 1996, shortly after passage of the Telecommunications Act, then-FCC chief economist Joseph Farrell assembled a discussion panel of leading telecommunications economists on the implications of BOC entry into long distance services. When asked about the possibility of misallocation of RBOC costs from an unregulated long-distance service into a regulated local service (for the purpose of raising local prices), Professor Jerry Hausman of MIT testified that “. . . we are here to make consumers better off, and therefore that leads me to the conclusion that *absent predation, cross-subsidy is really not a problem here. . .*” Testimony of Professor Jerry Hausman (emphasis added). *Id.*

retail DSL Internet access, SBC lacks any incentive to engage in such predation, which Earthlink incorrectly describes as a “cross-subsidy.”

25. In general, EarthLink fails to provide a coherent theory of consumer harm. If EarthLink cannot offer lower DSL Internet access prices because EarthLink is a less efficient retailer, then consumers are not worse off by SBC’s alleged refusal to lower its transport price. SBC’s low and allegedly “subsidized” retail DSL prices cannot possibly be harmful to consumers in the short run. And surely SBC lacks the market power to alter this conclusion in the longer run.

26. After trying to explain why competition at the end user level does not inform a cross-subsidy analysis, EarthLink offers several flawed arguments in support of the claim that the broadband Internet access services are not competitively supplied. For example, EarthLink incorrectly argues that “[r]elying on high HHI to infer that market is not competitive” is an appropriate standard of antitrust economics.²⁵ Yet concentration measures, such as HHI calculations, *by themselves*, do not serve as a good predictor of pricing behavior.²⁶ They are especially irrelevant in examining individual conduct in rapidly evolving markets such as broadband (where only 25 percent of U.S. households subscribe to the service), or when the defendant has less than 40 percent of the market share (the nationwide average DSL market share is 34.3 percent), or both.

25. *Id.* at 32 ¶ 35 n. 102, ¶ 39.

26. *See, e.g.*, Jonathan B. Baker & Daniel L. Rubinfeld, *Empirical Methods in Antitrust Litigation: Review and Critique*, 6 AM. L. & ECON. REV. 386, 388 (1999) (explaining how new empirical methods are preferred to “relying exclusively on presumptions about the anticompetitive consequences that flow from a particular industrial structure.”).

27. Next, EarthLink cites an FCC statistic showing that “15 percent of zip codes have only one broadband Internet provider”²⁷ as evidence that the marketplace is not competitive. This figure is grossly misleading for several reasons. First, not all zip codes have the same number of potential broadband subscribers, and the 15 percent of zip codes where only one provider has sold broadband service are in general far less heavily populated than the zip codes in which there are multiple broadband providers.²⁸ Second, not all of those zip codes in which only one provider has sold broadband service are served exclusively by DSL—that is, in at least some of those zip codes, the cable provider is the sole supplier. Indeed, cable modem service is available to more homes than DSL. Third, EarthLink has not provided any evidence that it wants to compete in these geographic areas, which, as noted above, tend to be less populous than areas with multiple providers. Fourth, because the broadband industry is evolving rapidly, this snapshot of deployment as of December 2003 is already stale. For example, in the five intervening months since the FCC issued those statistics (and the 11 plus months since the end of the period being measured), Comcast has expanded its network significantly in several geographic markets, including San Francisco, San Jose and Chicago.²⁹ Fifth, to the extent that some DSL provider is the sole supplier in a given zip code, it does not follow that SBC is that supplier or that it can exploit monopoly power in that or some other zip code. SBC cannot efficiently market its DSL

27. *EarthLink Reply* at 34 ¶ 37.

28. High-Speed Services for Internet Access: Status as of December 31, 2003 (released June 2004) at 4 (“High population density has a positive association with reports that high-speed subscribers are present, and low population density has an inverse association.”)

29. *Marching Towards A 10 Million HSD Sub Future*, MERRILL LYNCH 3Q04 EARNINGS ANALYSIS, Oct. 28, 2004, at 3 (“High-speed data net adds of 549,100 well ahead of our 500,000 estimate (which we had upwardly revised from our prior 400,000 estimate), or 42,200 per week versus 36,400 a week in the prior year period. Boost from NFL and other differentiated content on broadband and *footprint expansion* as broadband service is introduced in high-potential upgraded areas such as San Francisco, San Jose and Chicago.”) (emphasis added).

services at different prices in adjacent or nearby ZIP codes. In fact, SBC offers uniform prices throughout its region and markets its DSL service on a regionwide basis.

III. REGULATING THE PRICE OF DSL TRANSPORT OR DSL INTERNET ACCESS WILL HARM CONSUMERS

28. EarthLink is essentially pleading for its resale margin (equal to the difference between the retail rate and the wholesale rate) to be increased. Rate regulation, however, is unnecessary wherever market forces can be depended upon to promote the interests of consumers, as is the case here. The so-called “duopoly” about which EarthLink complains has resulted in nearly a 50 percent price decline over the past three years (from \$51 per month in July 2001 to \$26 per month in July 2004) and prices are continuing to decline.³⁰ In fact, nearly every major broadband provider has reduced its price or increased its speed or both in the past several months.³¹ Regulation is not only unnecessary in this case, it is potentially harmful. In particular, regulating one competitor while not regulating the other could retard investment and thereby skew the evolution of broadband competition.

30. *EarthLink Reply* 34 ¶ 37.

31. *See, e.g., Verizon, DSL For Home, <http://www22.verizon.com/ForHomeDSL/channels/dsl/forhomedsl.asp?ID=Res>* (“Business and Residential online DSL orders receiver the first month free”); SBC News Release, SBC Communications Announces \$19.95 Monthly Residential Pricing For SBC Yahoo! DSL - Lowest Broadband Price Ever, (Oct. 28, 2004) (“Effective Monday, Nov. 1, SBC Yahoo! DSL will be available for \$19.95 a month for new DSL residential customers who commit to a one-year term and subscribe to the popular SBC unlimited local and long distance calling plan, All Distance.”); Qwest News Release, Qwest DSL Modem Gives Customers Headstart on Wi-Fi Networking Solution, (Apr. 8, 2004) (“Customers [who accept the Wi-Fi capable modem] will save approximately \$50 on their Wi-Fi network setup costs because Qwest’s solution does not require additional hardware for the modem, just a wireless network card for each computer.”); Cablevision News Release, Cablevision News Release, *Cablevision's Optimum Online Increases Average Downstream Speed 40 Percent With No Price Increase*, (Oct. 12, 2004) (“Optimum Online customers are now experiencing average downstream speeds of 5 megabits per second, a 40 percent increase from just two years ago, at no additional cost.”).

A. A Mandatory Decrease in SBC's Transport Rate Will Result in a Misallocation of Resources Toward Resellers and Away from Facilities-Based Competitors

29. As the FCC recognized in its recent *Forbearance Order*, regulating SBC's wholesale rates could undermine the development of inter-modal competition.³² In particular, the FCC recognized that regulatory interference at the wholesale level, which from an economic perspective is similar to the kind now sought by EarthLink, could adversely affect the development of new broadband platforms employing emerging technologies. The FCC also observed that there are private incentives for broadband service providers to offer voluntary wholesale arrangements.³³ Moreover, it is unclear what would be gained by regulating SBC's wholesale rate only. Even assuming that SBC's wholesale rate were reduced through price regulation,³⁴ as long as SBC decreases its retail rate in response to competition from cable modem providers, competitors like EarthLink would still experience shrinking margins and therefore would still have the same complaint.

30. As the FCC recognized in its recent *Forbearance Order*, SBC has the appropriate economic incentives to set its access rate at a rate that would make its wholesale service attractive to a reseller that has lower retail costs than SBC or that can extend SBC's reach into new markets. If the FCC were to mandate a reduction in the price of access to SBC's network, the agency would be forcing SBC to enter into contracts with resellers that are neither more efficient than SBC (have higher retail costs) nor extend SBC's reach into the marketplace. If the

32. *Forbearance Order* at 13-14 ¶ 26 (explaining that without mandatory access, "competitive LECs would still be able to access other network elements to compete in the broadband market or take advantage of the opportunities presented by the developing market situation to build their own facilities or obtain access to facilities from other suppliers.").

33. *Id.*

34. As we understand it, under current regulatory rules, while SBC has an obligation to provide DSL transport service at "just and reasonable" rates, the FCC has not set a regulated price for DSL transport nor has it articulated any binding rate standard.

wholesale price were low enough, these less efficient resellers might place downward pressure on end user prices. Hence, an access rate reduced through regulatory intervention might result in consumer welfare gains in the short run, although the loss in producer welfare might offset the gain in consumer welfare from this inefficient rearrangement of market functions. In addition, the loss in dynamic efficiency that would result from the dampened incentives of DSL providers to invest and to innovate, would over the long term likely swamp the short-run increase in consumer welfare. Because there is no evidence of market failure at the end user level—indeed, broadband Internet access prices continue to fall—the potential short-run gain in consumer welfare from regulated wholesale prices would be small or nonexistent.

B. Retail Price Regulation Will Undermine Competition in Broadband Internet Access at the Retail Level

31. Because the broadband Internet access marketplace is evolving rapidly,³⁵ and because retail prices have declined by almost 50 percent since 2001, regulation of retail prices is not necessary to promote consumer welfare. Indeed, regulation of retail prices would likely harm consumers. In particular, constraining SBC's ability to *lower* its DSL prices to end users—the only way to ensure that EarthLink can earn a given margin—would allow cable modem operators, who already serve 63 percent of all residential broadband customers,³⁶ to take customers away from SBC. In general, the type of end user price regulation that EarthLink seeks would distort the normal function of the market to send correct signals and allocate resources in accordance to their most efficient use.

35. High-Speed Services for Internet Access: Status as of December 31, 2003 (released June 2004) at 4 (“Moreover, numerous competing providers report serving high-speed subscribers in the major population centers of the country.”).

36. High-Speed Services for Internet Access: Status as of December 31, 2003 (released June 2004) at tbl. 3.

CONCLUSION

32. EarthLink has failed to demonstrate that SBC engaged in cross-subsidy or discrimination as an economic matter. For example, EarthLink has not satisfied the necessary conditions for cross-subsidization as elaborated by former FCC Chief Economist Gerald Faulhaber. Moreover, EarthLink's cross-subsidy theory does not make sense because it does not involve two separate services. EarthLink also fails to understand how market forces discipline SBC's pricing of DSL transport. Even if there were a cross-subsidy or discrimination, Earthlink cannot prove it is harming consumers. A cross-subsidy raises no issue of consumer harm in the absence of a threat of market power in the subsidized market.

33. Regulating the price of DSL transport *and* DSL Internet access, which is EarthLink's real agenda, will harm consumers. Retail price regulation will undermine competition at the end user level by lessening the incentives of broadband providers to innovate and offer new services. By regulating the wholesale price of access to SBC's network, the FCC would effectively be forcing SBC to enter into contracts with resellers that are neither more efficient than SBC (have higher retail costs) nor expand SBC's offering into new areas. Whether it is aimed at the retail level or the wholesale level or both, regulation of the kind now sought by EarthLink will cause harm to consumers by hampering local competition and discouraging broadband deployment.

34. Although the FCC's decision to forbear from regulation directly addressed the ILECs' petitions regarding fiber to the home (FTTH) loops, fiber to the curb (FTTC) loops, the packetized functionality of hybrid loops, and packet switching, its order provided an accurate depiction of the necessity of regulation of broadband service in general. Applying the same logic

to DSL transport would result in the same conclusion—that is, that intermodal competition between broadband service providers creates the proper economic incentives at the wholesale level as well, reducing the need for intrusive regulation. The detriments to the marketplace, the consumer, and the public resulting from requiring the unbundling of DSL transport outweigh the benefits.

* * *

We declare under penalty of perjury that the foregoing is true and correct.

Executed on December ____, 2004.

Robert W. Crandall

Hal J. Singer