UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

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

In the Matter of

Deployment of Wireline Services Offering **CC**
Docket No. 98-147
Advanced Telecommunications Capability

Comment of the
Staff of the Bureau of Economics of the
Federal Trade Commission(1)

I. Introduction and Summary

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciates this opportunity to provide its views on the competition issues raised in the above-captioned proceeding. In this proceeding, the Federal Communication Commission (FCC) has proposed a framework that it believes will encourage the development and deployment of advanced telecommunications services(2) by incumbent local exchange companies (LECs).

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of consumers. The staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy, and has submitted comments to regulatory bodies at both the federal and state levels. For example, the staff has submitted comments to the FCC on television and radio ownership rules and policies; competition, rate deregulation, must carry, and other cable television issues; common ownership of cable systems and national television networks; network ownership of financial interests and syndication rights; spectrum allocation and standards for digital audio broadcasting; price caps for common carriers; and the regulation of 900 number telephone services. Moreover, the FTC has reviewed proposed mergers involving communications and media companies.

In this comment, we discuss the trade-offs involved with the FCC's proposal to use separate affiliates to provide advanced services. In addition, we discuss ways in which the FCC may want to strengthen its separate affiliate rules if it intends to permit LECs to offer advanced services free from incumbent LEC regulation. In particular, we discuss the implications of the affiliate's use of the parent LEC's logo, name, trademarks, etc. and joint marketing between the LECs and their affiliates.

II. Use of Separate Affiliates to Encourage LEC Deployment of Advanced Services Involves Trade-Offs

The Telecommunications Act of 1996 (Telecom Act) required LECs to open their networks to competitors through interconnection, sale of unbundled network elements, and resale of services.(3) The FCC has concluded tentatively that this requirement applies equally to the provision of advanced services as to the provision of traditional circuit-switched voice services.(4) LECs have claimed that requiring them to provide access to advanced services (on a resale basis or as unbundled elements) at regulated, wholesale prices discourages them from deploying such

services.(5) To remedy this claimed disincentive, the FCC has proposed as an alternative option: LECs could form "truly separate" affiliates that offer advanced services. The FCC believes that the interconnection and resale requirements of the Telecom Act would not apply to the LEC's separate affiliate offering advanced services.(6)

The use of separate affiliates, however, involves trade-offs. In order to avoid potential anticompetitive problems resulting from cross-subsidization and discrimination (discussed below), the unregulated affiliate must operate according to rules that effectively separate it from the regulated LEC parent, which controls the local network. But, if the affiliate is "truly separate" from the LEC, it may be unable to obtain the network economies of scale and scope that are available to the LEC. Recognizing this fundamental trade-off, the FCC should ensure it does not adopt weak separation rules. Although they may encourage certain efficiencies between a LEC and its affiliate, weak separation rules also may thwart the development of a competitive advanced services market.(7)

III. The Proposed Separate Affiliate Requirements Should Be Strengthened

The FCC is concerned about the potential for harmful cross-subsidization and anticompetitive discrimination in transactions between regulated incumbent LECs and their unregulated advanced services affiliates. The FCC's proposed requirements for separation of the LEC from its affiliate should reduce this potential from several sources.(8) The FCC, however, may wish to consider two additional requirements to further reduce the potential for harmful cross-subsidization and discrimination in transactions between the LEC and its advanced services affiliate.(9) First, the FCC may wish to consider restricting the affiliate's use of the incumbent LEC's corporate name or logo if certain circumstances prevail. When unregulated affiliates are allowed to use a regulated incumbent LEC's corporate name or logo, the LEC may have incentives to overinvest in building its reputation (as a provider of high-quality services, for example) to enhance the reputation of both it and its affiliates. This may be done in ways that are difficult for regulators to detect and prevent, resulting in harmful effects in both the regulated and unregulated markets. Second, the FCC may want to impose restrictions on joint marketing activities between the LEC and its affiliate to prevent harmful discrimination. This is especially pertinent for referrals from the LEC to its advanced services affiliate.

For both of these restrictions, as well as the other restrictions proposed, the FCC may wish to reconsider the need for them at a specified future date after market conditions have changed. For example, if competition emerges in the market for local telephone service, the incentive to cross-subsidize may be diminished.

A. An Affiliate's Use of the Parent Firm's Logo

In examining whether affiliates of regulated firms should be allowed to use the regulated firm's logo,(10) a comparison of the benefits and costs of doing so may provide helpful insights. There are at least two potential benefits to consumers. One may be reduced prices in the market served by the affiliate. With access to the parent company's logo, the affiliate is likely to have lower marginal marketing costs that are likely to be passed along to consumers in a competitive market. The lower prices of the affiliate may encourage other firms serving this market to charge lower prices as well, resulting in lower prices for the market as a whole.(11) Reduced consumer search costs may be another benefit if consumers' perceptions of the implications of an affiliate's use of the parent utility's logo are accurate (e.g., that the affiliate firm is not a fraudulent operator). These benefits, however, must be weighed against the potential costs associated with use of the logo by affiliates as discussed in the following sections.

1. Potential Cross-Subsidization

Allowing firms subject to cost-of-service regulation to diversify into unregulated markets can create the risk of anticompetitive cross-subsidization. Regulated entities will have an anticompetitive incentive to enter unregulated markets whenever they can falsely attribute to the regulated service some or all of the costs of providing the unregulated service. If regulated prices are based on reported costs, successful cross-subsidization would permit the monopolist to set the price of the regulated service closer to the (unregulated) profit-maximizing level. In the extreme, successful cross-subsidization could render price regulation completely ineffective.(12) Moreover, successful cross-subsidization distorts competition in the unregulated markets.

Generally, there are three methods for deterring cross-subsidization. Firms can be prevented from diversifying into unregulated markets, thereby eliminating the opportunity to cross-subsidize. Second, the regulator can divorce regulated prices from reported costs (e.g., by adopting "price-cap" regulations), thereby eliminating the incentive to anticompetitively diversify.(13) To the extent, however, that price caps are periodically adjusted to constrain the profitability of the regulated firm, as is common, they may reduce, but not eliminate, the incentives to cross-subsidize. Third, the regulator can mandate the use of rules, such as accounting techniques, designed to minimize the regulated firm's ability to misrepresent its costs. The effectiveness of this approach will be attenuated if firms are able to configure their production processes or operations to maximize the sharing of inputs by the parent and the unregulated affiliates. In that case, it will be difficult to attribute costs to either entity in an economically meaningful way.(14) It is for this reason that the sharing of a logo by the regulated and unregulated entities is potentially problematic for it could constitute a particularly difficult-to-detect form of cross-subsidization.(15)

The risk of failing to detect anticompetitive cross-subsidization is heightened if (1) the reputation of the regulated parent is effectively embodied or represented by its logo; (2) the regulated parent can improve its reputation by incurring costs of the type that regulators would traditionally include in the rate base of the regulated firm; and (3) the unregulated affiliate can enhance its own reputation among consumers by using the logo of the regulated parent firm, even if elements of the regulated firm's reputation do not apply to the affiliate. When these factors are present, a regulated incumbent will have a heightened incentive to overinvest in reputation-building because it can expect to incorporate a greater share of these investments into its rate base than if the assets were not shared with the affiliate. Moreover, the affiliate would realize additional profits from its increased sales in the unregulated market for advanced services. The principal obstacle to deterring this conduct is that it may be extraordinarily difficult to distinguish competitive from anticompetitive levels of investment in reputation building. Harm to competition and consumers may result from such overinvestment and subsequent cross-subsidization.

As noted above, successful cross-subsidization will harm consumers in the regulated market by allowing the firm to set prices closer to the (unregulated) monopoly level. There also may be welfare reductions in the unregulated market. The incentive to expand output or offer more services in the unregulated market may induce the firm to set price sufficiently low that it displaces more efficient rivals, thereby raising the total social cost of producing the unregulated product. This is a form of predation that might not be otherwise profitable were it not for the prospect of cross-subsidization. Similarly, because potential entrants into the unregulated market recognize the regulated entity's incentive to maintain its output level (in the unregulated market) in the face of competitive entry, they may infer that post-entry prices would be too low to allow such entry to be successful. This could allow the regulated firm to set a monopoly price in the unregulated market without attracting entry.(16)

2. Potential Deception of Consumers

While the logo may convey useful information about the limited relationship between the affiliate and the parent (e.g., that the affiliate is not a fraudulent business), it may also convey a deceptive claim if it leads consumers to believe that the relationship between the affiliate and the regulated firm is closer than it really is. For example, an element of a parent firm's reputation might be the credibility of its pledges of high-quality service that are backed by the parent firm's financial stability as a firm that operates under rate-of-return regulation. If a consumer imputed this same credibility to an affiliate's promises of high-quality service because of its use of the parent's logo, when in fact the affiliate did not have the same level of financial stability, the consumer could be injured if the affiliate was unable to fulfill its promises in the way the consumer expected, or if the consumer paid more for the product than it would have otherwise. If use of the logo misleads consumers to their detriment, it harms consumers and competition in much the same way as any deceptive advertising.

Deceptive advertising is prohibited under Section 5 of the Federal Trade Commission Act.(17) The FTC generally considers advertising deceptive if at least a substantial minority of consumers acting reasonably takes a particular message from an advertisement, and if that message is likely to mislead consumers to their detriment.(18) Thus if the FTC were to consider whether an affiliate's use of the incumbent LEC's logo is deceptive, the FTC would examine what message the logo conveys to consumers concerning the relationship between the affiliate and the incumbent

LEC, as well as whether that message is likely to influence the consumers' purchase decisions. If use of the logo implies to consumers that the relationship is different than what it really is, such use of the logo could be considered deceptive. If this deception results in consumer injury or harm to competition, the FCC may wish to restrict the affiliate from using the parent's logo.(19)

3. Regulatory Approaches to the Affiliate's Use of a Parent Firm's Logo

Given the concerns associated with the affiliate's use of a parent firm's logo, the FCC may wish to consider various approaches that have been suggested to address the issue. For example, in the electric utility industry, some states have proposed to ban generally the use of the regulated distribution firm's logo by its affiliated sellers of electric and natural gas service.(20) This approach eliminates the possibility of deception and reduces the probability of cross-subsidization, both discussed above. This approach is consistent with an assessment that the likely costs of allowing affiliate use of parent distribution firm's logo outweigh the likely benefits.

Other states have considered an alternative approach that is intended to achieve the potential benefits of the affiliate's use of the parent firm's logo while reducing the costs. In particular, some states have considered allowing the use of the logo by affiliates of regulated electric utilities, contingent upon use of a disclaimer intended to avoid consumer deception.(21) A disclaimer that suffices to avoid consumer deception also may suffice to discourage cross-subsidization in the form of excessive investment in reputation. It may be difficult, however, to develop disclaimers that are simultaneously sufficient to avoid deception and succinct enough to make use of the regulated parent firm's logo practical for unregulated affiliates, given the proposed rules separating the management and financial condition of regulated parent firms from their unregulated affiliates.(22)

B. Prohibition on Joint Marketing

The FCC also may want to consider imposing conditions on the joint marketing of advanced services by the affiliate and the LEC. The proposed rules seek to prevent discrimination by requiring that any transaction between a LEC and its affiliate be on an arm's length basis, reduced to writing, and made available for public inspection. This safeguard, however, does not fully address the competitive advantage that the LEC has as the monopoly provider of local telephone service. On the other hand, there are cost advantages to having the LEC provide marketing services to all competing providers of advanced services, given its existing relationship with potential customers of such services.

In light of the LECs' monopoly in traditional telephone service, LECs will be uniquely positioned to market advanced services to their existing consumers, especially those customers with profiles that indicate they are likely to desire such services. First, they are in a position to suggest and to refer inbound service callers (those customers seeking new or additional traditional telephone services) to their affiliate, rather than to other providers of advanced services.(23) Second, the LEC customer data base is a unique asset that, if provided to the advanced services affiliate on superior terms (relative to competitors), may provide the affiliate with an advantage over its competitors that does not derive from superior efficiency, but merely from the LEC's incumbent status as the monopoly provider of local telephone services.

To reduce the potential for anticompetitive behavior by the LEC while at the same time allowing for efficiencies to be realized in the marketing of advanced services, the FCC may wish to impose certain conditions on joint marketing.(24) Specifically, the FCC could permit referrals to companies offering advanced services ("inbound telemarketing"(25)) provided that if the LEC offers such services to its affiliate, it also would have to make them available to all unaffiliated providers on the same terms and conditions. In addition, the FCC could require that the LEC make available to all competitors on the same terms and conditions any customer information that it provides to its affiliate. Such information might include, for example, a listing of all households with two or more telephone lines that could possibly be amenable to purchasing advanced services. For other types of marketing or advertising activities by the LEC, the FCC may wish to consider imposing prohibitions similar to those contained in the Telecom Act for a LEC's electronic publishing affiliate.(26) Alternatively, the FCC could permit certain activities subject to non-

discrimination requirements. Such restrictions will help foster a competitive market for advanced services from the outset.(27)

IV. Conclusion

The FCC has proposed requirements for advanced service affiliates to receive non-incumbent LEC status. The FCC may wish to strengthen these requirements by adding a requirement concerning an affiliate's use of the parent LEC's logo and restrictions on joint marketing activities between the LEC and its affiliate.

Respectfully submitted,

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1. This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner. Inquiries regarding this comment should be directed to Michael Wroblewski at (202) 326-2155.

2. Advanced telecommunications services include wireline, broadband digital services including those that rely on digital subscriber line and packet-switched technology.

3. 47 U.S.C. § 251.

4. Notice at ¶ 11.

5. Id. at ¶ 10.

6. If the LEC decides to offer advanced services on an integrated basis, the network unbundling and interconnection requirements will then apply to the LEC.

7. The FCC's separate-affiliate proposal is predicated on an expectation that the market for advanced services will be competitive, absent the problems discussed in this comment.

8. The FCC has proposed that the following requirements be met in order for an advanced services affiliate to be considered truly separate: (1) the incumbent must "operate independently" from its affiliate; (2) transactions must be on an arm's length basis, reduced to writing, and made available for public inspection; (3) the incumbent and affiliate must maintain separate books, records, and accounts; (4) the incumbent and advanced services affiliate must have separate officers, directors, and employees; (5) the affiliate must not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the incumbent; (6) the incumbent LEC, in dealing with its advanced services affiliate may not discriminate in favor of its affiliate in the provision of any goods, services, facilities or information or in the establishment of standards; and (7) an advanced services affiliate must interconnect with the incumbent LEC pursuant to tariff or pursuant to an interconnection agreement, and whatever network elements, facilities, interfaces and systems are provided by the incumbent LEC to the affiliate must also be made available to unaffiliated entities. The FCC seeks comment on the proposed requirements.

9. These suggestions are consistent with the staff's comments on electricity industry deregulation to the Federal Energy Regulatory Commission (see, e.g., Docket Nos. RM95-8-000 and RM94-7-001 (Aug. 7, 1995)) and to various state agencies (see, e.g., Public Utilities Commission of Nevada, Docket No. 97-5034 (Sept. 22, 1998); Public Utility Commission of Texas, Project No. 17549 (June 19, 1998)). Staff comments can be accessed from the FTC's website <www.ftc.gov/be/advofile.htm>.

10. We use the term "logo" here to include the logo, name, and other elements used to identify the regulated firm.

11. If the competing firms do not respond with lower prices, the affiliate likely will gain market share and the average price in the market will be lower because of affiliate's lower marginal costs.

12. For an analysis of cross-subsidization by Timothy Brennan, see Timothy Brennan, Is the Theory Behind U.S. v. AT&T Applicable Today?, Antitrust Bulletin 455-82 (Fall 1995); Cross-Subsidization and Cost Misallocation by Regulated Monopolists, 2 Journal of Regulatory Economics 37-52 (1990); Why Regulated Firms Should be Kept Out of Unregulated Markets: Understanding the Divestiture in United States v. AT&T, Antitrust Bulletin 741-93 (Fall 1987);

13. We recognize that the FCC and some states have adopted various forms of price caps to constrain the prices of a LEC's regulated service offerings.

14. See, Braeutigam, An Analysis of Fully Distributed Cost Pricing in Regulated Industries, Bell J. of Econ. 182-96 (Spring 1980).

15. Shared inputs obviously can be a source of economic efficiency (scope economies) as well as a vehicle for harmful cross-subsidization.

16. See, e.g.,supra note 11, Brennan (1995 at 465; 1990 at 44; 1987 at 762).

17. 15 U.S.C. § 45. The FTC does not regulate advertising by common carriers.

18. See Federal Trade Commission's Policy Statement on Deception, letter to Hon. John D. Dingell, Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives (Oct. 14, 1983), appended to Cliffdale Associates, 103 F.T.C. 110 (1984).

19. Consumer injury might arise, for example, if the affiliate failed to provide the anticipated level of service reliability, forcing consumers to incur the costs of obtaining access to alternative sources of supply. Harm to competition might take the form of more efficient entrants being unable to gain market share due to consumers' reliance on the deceptive claims of the affiliate.

20. See, e.g., Proposed Rulemaking to establish standards of conduct and related requirements for distribution companies and affiliates, Public Utilities Commission of Nevada, Docket No. 97-5034. Such a rule also is consistent with a settlement reached by the Georgia Public Service Commission and Atlanta Gas Light Company (AGL). Under the settlement, AGL's marketing affiliate will not be able to use the name "Atlanta Gas Light" as it competes with other marketers to sell natural gas to consumers. See News Release, Georgia Public Service Commission (Aug. 20, 1998) <www.psc.state.ga.us/press/releases/98/082098.htm>.

21. See, e.g., Establishing Standards of Conduct Governing the Relationship Between Electric Distribution Companies and Their Affiliates and Between Natural Gas Local Distribution Companies and Their Affiliates, Massachusetts Department of Telecommunications and Energy, D.P.U./D.T.E. 97-96 (May 29, 1998); Promulgation of New Rules Governing Activities Between Affiliates, Public Utility Commission of Texas, Project No. 17549, 23 Tex. Reg. 5294 (May 22, 1998) (proposed rules governing the transactions between regulated electricity firms and their unregulated affiliates).

22. Consumer research can be used to evaluate the impressions conveyed to consumers by the logo accompanied by a disclaimer.

23. It has been suggested that the LECs also may enjoy a competitive advantage in the advanced services market because as LECs deploy advanced services, they will transfer their customers off their existing circuit-based networks onto networks capable of handling advanced services. (See, e.g., Andrew Kupfer, The Real King of the Internet, Fortune, Sept. 7, 1998, 84.) In this environment, LECs may get a disproportionate share of inquiries for advanced services by virtue of their regulated monopoly status, even though an affiliate, rather than the LEC itself, may be offering advanced services.

24. Even if Section 222 of the Telecom (47 U.S.C. § 222) imposes these restrictions on LECs and their affiliates, the FCC may wish to explicitly include them in the separation requirements for LEC affiliates offering advanced services to ensure that all parties know that Section 222 applies to these affiliates as well.

25. 47 U.S.C. § 274(i)(7).

26. Id. at § 274(c). These prohibitions include, for example, restrictions on joint promotion, marketing, sales and advertising between a Bell operating company and its separated electronic publishing affiliate.

27. A number of states have included prohibitions on joint marketing in the electricity deregulation context, including Nevada, Massachusetts, and Wisconsin.