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Decision 98-08-068 August 31, 1998

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In re Application of WorldCom, Inc. and MCI Communications Corporation for Approval to Transfer Control of MCI Communications Corporation to WorldCom, Inc.	Application 97-12-010 (Filed December 5, 1997)

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OPINION

In this opinion, we approve the proposed merger between MCI Communications Corporation (MCIC) and WorldCom, Inc. (WCOM) (also jointly referred to as applicants) as in the public interest under Public Utilities (PU) Code § 854(a).

Procedural Background

I. The Application

On December 5, 1997, MCIC and WCOM filed the instant application seeking expedited, ex parte approval under PU Code § 854(a) for the change in control of MCIC's five California certificated carriers. These subsidiaries are: (1) MCI Telecommunications Corporation (MCIT), an interexchange carrier providing interLocal Access and Transport Area (LATA) and intraLATA private line and metered services and intrastate resale switched cellular services; (2) MCImetro Access Transmission Services, Inc., a competitive local exchange carrier (CLEC) operating in the service area of Pacific Bell which also provides intraLATA toll services and switched and special access service intrastate; (3) Teleconnect Company, an interexchange carrier providing interLATA and intraLATA metered services; (4) Teleconnect Long Distance Services and Systems, an interexchange carrier providing interLATA and intraLATA private line services; and (5) Nationwide Cellular Services, Inc., a cellular carrier providing intrastate resale switched cellular service and interexchange metered services.[1]

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[1] In Decision (D.) 97-07-060 we approved the then proposed merger of MCIC into British Telecommunications plc (BT). Subsequent to our approval, this merger was not consummated and MCIC agreed to be acquired by WCOM, and WCOM agreed to pay

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actual number of shares of WCOM common stock to be exchanged for each MCIC share will be determined by dividing $51 by the 20-day average of the high and low sales prices for WCOM common stock prior to closing, but will not be less than 1.2439 shares or more than 1.7586 shares. Cash shall be paid for fractional shares. Shareholders other than BT do not have appraisal rights. BT, the holder of a 20% interest in MCIC will receive $51 per share in cash for each share of its MCIC Class A common stock. This price was arrived at in consideration of BT's waiver of its special rights and privileges under its Class A stock and waiver of its appraisal rights thereunder. The estimated price of the acquisition is $44 billion. Upon completion of the merger, current shareholders of MCIC's common stock will own approximately 45% of the combined company. As a result of the exchange of MCIC shares, MCIC will become a wholly owned subsidiary of WCOM. MCIC will then immediately be merged into T.C. Investments Corp.(TCIC), another wholly owned subsidiary of WCOM. TCIC's name will be changed to MCI Communications Corporation (new MCIC) upon consummation of the MCIC-TCIC merger. Thus, MCIC will become a wholly-owned subsidiary of WCOM.

Because of the merger of the two holding companies, all certificated California carriers owned by MCIC will thus become indirectly owned by WCOM. MCIC will continue to provide telecommunications services subject to the Commission's jurisdiction. Upon consummation of the change in control, WCOM will then change its name as the parent company to MCIWorldCom.

Bert C. Roberts, Jr., the chairman of MCIC, will be appointed chairman of the new holding company MCIWorldCom. Gerald H. Taylor, Chief Executive Officer (CEO) of MCIC, will become vice chairman of MCIWorldCom and be responsible for all international operations. Bernard J. Ebbers, CEO of WCOM will become president and CEO of MCIWorldCom. Timothy F. Price, president

III. The Protest Period

Notice of the application appeared in the Commission's Daily Calendar of December 10, 1997. The protest period expired on January 9, 1998. Five protests were filed.

IV. The Protests

We review below the gravamen of each of the protests.

A. Greenlining/Latino Issues Forum (G/LIF)

G/LIF wants a commitment by the applicants to serve and benefit all communities. Until G/LIF can be so assured, they protest because a PU Code § 854(b) and (c) exemption should not apply to this transaction as it did to the proposed merger of MCIC and BT. G/LIF also alleges the application does not include sufficient facts to support its statement that the merger is in the public interest and will benefit the consumers of California. G/LIF protest the lack of a showing under PU Code §§ 854(b) and (c). They assert a hearing is necessary to ensure that vulnerable communities will receive the benefits of this merger as required under § 854(c). They urge that the SBC/Pacific Telesis merger decision serve as a benchmark in terms of the public interest considerations the Commission is compelled to make under § 854, regardless of whether applicants' rates are totally regulated or not.

B. GTE Communications Corporation (GTEC)

GTEC wants the request for an exemption denied, alleging serious competitive concerns are raised by the merger. GTEC also contends the application should be rejected on its merits because (1) the horizontal merger of direct competitors will have serious anti-competitive effects and is inconsistent with the public interest since applicants are the number 2 and 4 facilities-based, long distance carriers; and (2) applicants have failed to satisfy their burden of

Communications Workers of America (CWA) protest in this regard (see section IV.E. below). GTEC also elaborates on internet issues it believes the merger raises. GTEC notes that the merged entity will have a bottleneck over interconnection and an unparalleled ability to exploit network externalities, create a significant barrier to entry, and threaten to cut off rival national backbones, thus causing these backbones to pay inflated prices for interconnection. Otherwise, failure of a backbone to upgrade its interconnection with another major national network would cause service degradation for its own customers. GTEC also observes that the merged entity will control the most critical interconnection points of the internet, the Metropolitan Area Exchange (MAE) facilities. These are the hubs where virtually all smaller backbones interconnect with major national networks. Two significant MAEs are located in California. Thus, GTEC contends that ownership and operation of MAEs will give the merged entity power to degrade the quality of the interconnections its rivals maintain with non-MCIC/WCOM networks.

C. The Utility Reform Network (TURN)

Citing the unprecedented size of this merger, TURN asserts the merger is bad for consumers, especially residential and small business customers. TURN believes approval would trigger a domino effect leading to a tight oligopoly of telecommunications titans. Therefore, it requests that the Commission deny the merger. The specific grounds for protest are: (1) the acquisition will lead to excessive concentration in the long distance market; and (2) the acquisition will undermine competition for local exchange service, especially for residential customers.

Specifically, TURN alleges that the combination of the applicants' CLECs will decrease choices for local exchange service and reduce investment in local exchange facilities due to the expense of the acquisition. Because of the high

CORRECTION !!

THE PREVIOUS DOCUMENT(S) MAY HAVE BEEN FILMED INCORRECTLY .....

RESHOOT FOLLOWS

OPINION

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WCOM's California certificated carriers are: BLT Technologies Inc., a facilities-based (FB) carrier providing prepaid calling cards; TTI National Inc., an FB long distance carrier; Touch 1 Long Distance Inc., an FB long distance carrier; Choice Communications, Inc. d/b/a WorldCom Wireless, a cellular reseller; WorldCom Network Services, Inc. d/b/a WilTel Network Services, an FB carrier offering private line and long distance services primarily to resellers; Brooks Fiber Communications, Inc. and its five operating subsidiaries offering local and long distance services; WorldCom Technologies, Inc., an FB carrier offering local and long distance services; ALD Communications, Inc., an FB carrier offering long distance services; Bittel Telecom, Inc., an FB carrier offering long distance services; and Metropolitan Fiber Systems of California, Inc., an FB carrier offering local and private line services.

Pursuant to § 7.1(b) of the Agreement and Plan of Merger (Agreement), the termination date for the transaction is December 31, 1998. If WCOM fails to close the transaction and certain conditions are met by MCIC, it agrees to pay MCIC $1.635 billion in cash and BT $250 million. MCIC is required to pay WCOM $750 million and to reimburse WCOM its $465 million merger termination payment to BT if MCIC agrees to be acquired by another entity.

Under the Agreement, dated as of November 9, 1997, each issued and outstanding share of common stock, par value $0.10, of MCIC, other than shares already owned directly or indirectly by British Telecommunications plc (BT) or MCIC, will be converted into the right to receive ordinary shares of WCOM. The

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BT a $465 million fee to terminate its merger agreement with MCIC. In D.97-05-092 and D.97-07-060, we granted the transaction an exemption from scrutiny under PU Code §§ 854(b) and (c) and approved it under PU Code § 854(a) based on the facts and circumstances of that proposed transaction.

actual number of shares of WCOM common stock to be exchanged for each MCIC share will be determined by dividing $51 by the 20-day average of the high and low sales prices for WCOM common stock prior to closing, but will not be less than 1.2439 shares or more than 1.7586 shares. Cash shall be paid for fractional shares. Shareholders other than BT do not have appraisal rights. BT, the holder of a 20% interest in MCIC will receive $51 per share in cash for each share of its MCIC Class A common stock. This price was arrived at in consideration of BT's waiver of its special rights and privileges under its Class A stock and waiver of its appraisal rights thereunder. The estimated price of the acquisition is $44 billion. Upon completion of the merger, current shareholders of MCIC's common stock will own approximately 45% of the combined company. As a result of the exchange of MCIC shares, MCIC will become a wholly owned subsidiary of WCOM. MCIC will then immediately be merged into T.C. Investments Corp.(TCIC), another wholly owned subsidiary of WCOM. TCIC's name will be changed to MCI Communications Corporation (new MCIC) upon consummation of the MCIC-TCIC merger. Thus, MCIC will become a wholly-owned subsidiary of WCOM.

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Bert C. Roberts, Jr., the chairman of MCIC, will be appointed chairman of the new holding company MCIWorldCom. Gerald H. Taylor, Chief Executive Officer (CEO) of MCIC, will become vice chairman of MCIWorldCom and be responsible for all international operations. Bernard J. Ebbers, CEO of WCOM will become president and CEO of MCIWorldCom. Timothy F. Price, president and Chief Operating Officer (COO) of MCIC will become president and CEO of MCIC's U.S. operations. John W. Sidgmore will continue as vice chairman and COO, and Scott D. Sullivan will continue as Chief Financial Officer.

WCOM, a Georgia corporation, headquartered in Jackson, Mississippi, is authorized to transact business in California. Through its subsidiaries, WCOM operates globally in more than 50 countries. It provides facilities-based and fully integrated local, long distance, international and internet services. WorldCom's subsidiary UUNet Technologies, Inc. (UUNet) is an international provider of internet services, but is not required to be certificated by this Commission or the Federal Communications Commission (FCC). WCOM's 1997 revenues were $7.35 billion.

MCIC is a Delaware corporation, headquartered in Washington, D.C. and authorized to transact business in California. Through its subsidiaries, MCIC provides common carrier communications services within California in the intrastate, interstate, and international markets. The MCIC group employs over 50,000 people. Its services include voice, data, messaging, facsimile, and a variety of enhanced services, including internet backbone services and retail internet services. MCIC's 1996 revenues stood at $18.5 billion.

II. Regulatory and Shareholder Approvals

We take official notice of the fact that the shareholders of both corporations have approved the merger, as has the European Commission (EC) and the United States Department of Justice (DOJ) with conditions to prevent anti-competitive behavior. The FCC has not yet acted upon applicants' application, nor have all of the states from which approval has been sought. The EC and DOJ approvals are discussed further in our antitrust analysis.

III. The Protest Period

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G/LIF wants a commitment by the applicants to serve and benefit all communities. Until G/LIF can be so assured, they protest because a PU Code § 854(b) and (c) exemption should not apply to this transaction as it did to the proposed merger of MCIC and BT. G/LIF also alleges the application does not include sufficient facts to support its statement that the merger is in the public interest and will benefit the consumers of California. G/LIF protest the lack of a showing under PU Code §§ 854(b) and (c). They assert a hearing is necessary to ensure that vulnerable communities will receive the benefits of this merger as required under § 854(c). They urge that the SBC/Pacific Telesis merger decision serve as a benchmark in terms of the public interest considerations the Commission is compelled to make under § 854, regardless of whether applicants' rates are totally regulated or not.

B. GTE Communications Corporation (GTEC)

GTEC wants the request for an exemption denied, alleging serious competitive concerns are raised by the merger. GTEC also contends the application should be rejected on its merits because (1) the horizontal merger of direct competitors will have serious anti-competitive effects and is inconsistent with the public interest since applicants are the number 2 and 4 facilities-based, long distance carriers; and (2) applicants have failed to satisfy their burden of proof that the merger is in the public interest under either §§ 854(a) or (b) and (c). GTEC protests the application's lack of a showing under § 854(c).

The anti-competitive effects asserted are the combined long distance market share of 25.5 post merger with an even greater market share in the business market. GTEC alleges that the Herfindahl-Hirschman Index (HHI) for the merger is such that it gives rise to a presumption the merger will create or facilitate the exercise of market power under DOJ guidelines. Also, GTEC contends that the merger will add retail consumers to WCOM's market which will encourage it to cease wholesale sales at aggressive rates to independent resellers and other customers for resale to that market.

GTEC also asserts that because WCOM and MCIC offer facilities-based local exchange service in San Francisco, Los Angeles, and San Diego, the merger will remove a facilities-based competitor from the local exchange market and result in decreased investment in the local loop. By removing one of the few facilities-based CLECs, GTEC claims the merger would undermine the Commission's policy of fostering facilities-based local exchange competition in California. It notes the application is silent on the actual effects of the merger on local competition.

Thus, GTEC requests hearings on the merger to show that the merger fails to provide short-term and long-term benefits to ratepayers and will have a negative effect on competition.

On February 17, 1998, GTEC filed an amendment to its protest to supplement its arguments regarding the impact of the proposed merger on the internet backbone market.[2] It adopts the arguments set forth in the

[2] This triggered a response period by all other parties. However, only applicants filed a response to the amended protest.

Communications Workers of America (CWA) protest in this regard (see section IV.E. below). GTEC also elaborates on internet issues it believes the merger raises. GTEC notes that the merged entity will have a bottleneck over interconnection and an unparalleled ability to exploit network externalities, create a significant barrier to entry, and threaten to cut off rival national backbones, thus causing these backbones to pay inflated prices for interconnection. Otherwise, failure of a backbone to upgrade its interconnection with another major national network would cause service degradation for its own customers. GTEC also observes that the merged entity will control the most critical interconnection points of the internet, the Metropolitan Area Exchange (MAE) facilities. These are the hubs where virtually all smaller backbones interconnect with major national networks. Two significant MAEs are located in California. Thus, GTEC contends that ownership and operation of MAEs will give the merged entity power to degrade the quality of the interconnections its rivals maintain with non-MCIC/WCOM networks.

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Specifically, TURN alleges that the combination of the applicants' CLECs will decrease choices for local exchange service and reduce investment in local exchange facilities due to the expense of the acquisition. Because of the high price for MCIC, TURN questions whether the combined company will have the financial ability to pursue the aggressive plans for expansion of local competition that each company has announced on a stand-alone basis. TURN fears that, due to these financial burdens and WCOM's disinterest in the residential local exchange market, the combined company will not to pursue this market sector. TURN also alleges the merger could result in removal of MCIC as a competitor in this market. TURN requests a full review under §§ 854(b) and (c) and alleges the merger fails to satisfy § 854(b)(1)'s benefits test, the § 854(b)(3) effect on competition test, and the tests of § 854(c) (1) (financial condition of resulting utility), (6) (benefit to state and local economies) and (8) (mitigation measures to prevent significant adverse consequences).

D. Office of Ratepayer Advocates (ORA)

ORA does not object to deciding this case under the § 853(b) exemption and § 854(a) analysis since nondominant carriers are involved, if the Commission will request the opinion of the Attorney General of the State of California (AG) under § 854(b)(3) and there is a demonstration that the merger is in the public interest. ORA wants a review of the competitive impacts under the stricter § 854(b)(3) analysis[3] and asserts the Commission should require the combined company not to cut back any intrastate residential service offerings.

ORA wants post merger monitoring of WCOM/MCIC residential service levels. ORA voices concerns that executed and proposed mergers of regional Bell operating companies (RBOCs) weigh against heated competition in the local market. ORA is also worried about the concentration in the

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[3] Section 854(b)(3) requires that the merger not adversely affect competition. Under § 854(a), we need only consider competitive impacts and can approve the merger in spite of them if it is in the public interest.

interexchange market because it asserts the two largest carriers post merger, AT&T and MCIC, may share as much as 80% of the market. However, it notes that while the combined company will have a greater market share in the interexchange market, it will have to continue to price aggressively to maintain or increase its market share. Therefore, ORA is more concerned about the local market in California because the merger could result in potential cutbacks in service to residential local exchange customers if competition continues to stall in this market.

ORA requests a two-year monitoring requirement to track price changes and revenues for business and residential local and toll services, by customer and service type, to track current residential and business customer levels, and to monitor levels monthly over the two-year period to determine whether a dichotomy develops. ORA also requests a Commission requirement that WCOM and MCIC not abandon residential local service in any existing California market. ORA also wants a requirement that WCOM and MCIC make an annual showing of their continued and growing presence in the residential market for local toll and local exchange services. ORA asserts that if post merger there is a pullback on residential service, then all competition in these markets will be aimed only at the business sector, where the profits and volumes are higher, leaving residential customers to pay higher rates. With this caveat as to residential service, ORA believes that the merger will enhance local competition.

ORA does not call for hearings.

E. Communications Workers of America

CWA calls for full evidentiary hearings. CWA asserts anti-competitive impacts of the merger. It alleges that the merged entity would control 63% of the US internet backbone market and thus adversely affect competition in this market. CWA asserts the merger would (1) eliminate MCIC as UUNet's largest major competitor; (2) create a market dominated by one powerful provider, with the next largest provider (Sprint) having a 30.5% market share; and (3) leave the market with only two significant market participants. Thus, CWA alleges competition would be adversely affected through the creation of one backbone provider with the ability to exercise market power to control prices and reduce access.

CWA also argues use of the HHI analysis on the merger produces a HHI increase that shows the merger is likely to create or enhance market power or facilitate its exercise.

Since there is no regulatory requirement that internet networks interconnect with each other on the internet, private network providers use voluntary peering arrangements under which roughly equivalent amounts of traffic are exchanged at no cost. These arrangements have traditionally allowed exchange of traffic for free. Pre-merger there are 9 backbone providers and 3000 internet service providers (ISPs). CWA alleges post merger that market power could be used to refuse interconnection to smaller players, thus pricing these ISPs out of the market, or to set pricing policies that discriminate in favor of the merged entity's own ISPs. CWA alleges that WCOM has begun charging smaller ISPs for peering arrangements and refusing interconnection to those unwilling to pay. Due to the merged entity's bottleneck control over ISP access to the backbone network, CWA contends that it could adopt pricing policies that favor interconnection with its own ISPs through cross-subsidies, predatory pricing or other practices.

CWA also asserts that the merger fails to provide short-term and long-term economic benefits under § 854(b)(1) and fails to maintain or improve the quality of service to public utility ratepayers in California under § 854 (c)(2). CWA notes that WCOM provides exchange access service to business customers in the major metropolitan areas of California and that its focus is the business market to the exclusion of residential customers. By merging with MCIC, CWA asserts that a vertically integrated company can arbitrage business opportunities through ownership of fiber ringing the central business districts in all major urban markets, a long distance network with 25% national market share and 63% market share of the internet backbone service and ownership of the largest ISPs (UUnet, first, MCIC second, and ANS 7th largest and Compuserve). By bundling these services, CWA contends that there will be a diversion of revenue off the public switched network and that the increase in access charge bypass will undermine universal service. The loss of these revenues by incumbents as carriers of last resort would pressure them to raise residential rates, especially in high cost areas, and to reduce network investment.

Due to WCOM's strategy to pursue the lucrative medium and large business market, CWA asserts that post merger MCIC will abandon its attempts to serve the residential and small business local exchange market. Thus, competition in this market will be decreased and investment in local loops will be reduced. CWA contends that the merger will eliminate the strongest potential competitor for facilities-based competition in this market. Therefore, it asserts the merger adversely affects competition and fails to meet the public interest standard.

Finally, CWA alleges that the reduced spending resulting from the merged entity's planned reduction in capital and operating expenses will result in significant job loss in California. Thus, it contends the merger fails to meet the § 854(c)(4) test of being fair and reasonable to affected public utility employees.

V. Applicants' Replies to the Protests

A. Reply

The applicants assert that, although the facts of this merger are somewhat different than in the proposed BT/MCIC merger, the underlying rationale of our opinion in that docket still applies to this merger. They note that the merger does not put together two traditionally regulated telephone systems, no ratemaking scheme exists to permit the allocation of merger benefits, and both entities are competitive, nondominant carriers whose facilities have been constructed by shareholders, not captive utility ratepayers. They assert their application, plus the attachment A to the Reply (the SEC filing on the merger) contains all the information necessary to analyze the transfer under the criteria used in the final BT/MCIC opinion, D.97-07-060.

As to antitrust concerns, applicants argue that the merger will have no anti-competitive effect in the interexchange market because it is highly competitive, with low entry barriers and constant new entrants denying applicants any ability to raise prices or restrict services. They note the interexchange market is characterized by intense competition and steadily declining prices, and that the merged company will be half the size of AT&T which has been found by the Commission to be nondominant. They assert that the consolidation of MCIC and WCOM is likely to create additional opportunities for entry. They observe that Qwest, IXC and Williams are building extensive networks to compete with the existing networks of applicant, Sprint and AT&T. These networks, in addition to the merged company's, will provide vigorous competition to sell interexchange services to other interchange carriers as well as bundled services to retail customers. Applicants refute GTEC's assertion that there would be no need to support wholesale business after the merger. They cite such wholesale business as a significant source of revenue. Indeed, applicants allege that GTEC makes this argument because the merged entity will increase competition for GTEC in this market.

Applicants question the propriety of GTEC's mechanical application of the HHI as unwarranted under the terms of the DOJ Merger Guidelines. They observe that DOJ looks to the relevant market and considers how consumers will be affected by, and how competitors will respond to, the proposed merger before the numbers calculated under HHI can be given meaning. These factors often demonstrate that, even if the HHI is high, a merger is unlikely to create or enhance market power or facilitate its exercise. Applicants allege this is the case here. Applicants also state that the reasons behind GTEC's protest is its desire to still acquire MCIC by a hostile tender offer and its fear of the merged company as a competitive threat to GTEC.

As to ORA's concerns about the impact of the merger on intraLATA toll competition, applicants assert that no concrete examples are cited. They contend that, once intraLATA equal access is implemented throughout California and dialing parity is available to all consumers, residential and small business customers will benefit from lower prices and innovative services. Applicants assert that the merged company will be better positioned to more effectively compete against the dominant providers of intraLATA toll service once the existing competitive barriers are removed.

Noting that ORA cited positive impacts of the merger on the local market, applicants refute GTEC's assertions to the contrary. They point to the number of CLECs operating in California markets of concern to GTEC and observe GTEC has yet to enter these markets as a CLEC. Admitting that local service competition has not developed to the extent many had hoped, applicants assert that, once the Commission solves the barriers to profitable and efficient operation, applicants believe the merged company will be the best positioned competitive carrier to enter. The merger will enable the expansion of network-based operations and use of unbundled loops plus combinations of unbundled network elements (UNEs) to more aggressively serve residential customers.

Applicants argue that they will not abandon the residential market as feared by ORA. The ability to offer one stop shopping is a great attractant for residential customers. They contend there is no intention to reduce investment in the local exchange by $5.3 billion over four years as asserted by CWA. These numbers come from WCOM's SEC filing and represent cost efficiencies in carrying out the plans to expand local service. Because WCOM already has facilities, MCIC post merger will be able to expand in local markets at lower costs than on a stand-alone basis. Thus, post merger there is no plan to reduce local service nor shrink expenditures for it. Applicants believe the merger will break open local exchange markets to more robust competition.

Applicants deny that post merger debt will impair the merged company's ability to provide local service through diversion of revenues to debt stream as alleged by TURN. The combined assets of the two companies will permit more effective competition and bring about local competition sooner and more tangibly. Applicants contend the combined company, by having local service facilities in place, will be able to reduce MCIC's historic losses, thereby creating more financial resources to allocate to capital investment rather than to funding operating losses. They note the financial analysts characterize the combination as positive from both a strategic and financial standpoint. Applicants assert they will not forgo expansion of local exchange facilities to fund merger debt, as the local competition benefits that will arise from the merger are a primary reason for the merger. It would be senseless to merge for this reason and then take steps to negate their ability to take advantage of their combined forces in this market.

Applicants contend CWA's argument that universal service support would be undermined is seriously flawed after the Telecommunications Act of 1996 (Telecom Act). The switch on the federal level to the new Universal Service Fund negates the diversion of the former implicit universal service subsidies through access charges. The merged company will still pay these charges. Thus, there is no bypass of access charges to the detriment of universal service. California's use of an end-user surcharge accomplishes the same purpose. They also note that strong local competition will drive down the price of local services for all consumers, thus making telephone service more affordable and more universally available.

Applicants observe the 75,000 employee reduction asserted by CWA is wholly without support and is based on speculation that the merger will result in fewer new hires over the next five years. With a projected 20% revenue growth post merger, applicants expect to add employees, not remove them.

Applicants refute the allegation they will have market power in the internet backbone services market. Applicants assert that no telecommunications regulatory body has jurisdiction over information services. It notes the concerns raised are being considered by federal antitrust enforcement authorities and that the Commission should defer review to them.

Even were the Commission to review the allegations as to this market, applicants assert the concentration data used by CWA and GTEC is flawed. First, applicants disagree that there is a separate internet backbone market. However, even if there is, there are 32 to 37 backbone providers, not the mere 9 cited by CWA. Applicants note that the provision of backbone services has relatively low barriers to entry. Applicants contend that, based on revenues, their combined share of the backbone market would only amount to 18%.

Applicants assert that the structure of the internet makes bottleneck control by backbone providers impossible. It is a market characterized by dynamic change, rapid growth and ease of entry. Applicants deny that WCOM has implemented a paid peering policy as alleged by CWA.

Finally, applicants refute G/LIF's arguments concerning adverse impacts on low income and minority communities. Applicants cite their low rates and continued expansion in minority communities. They point to MCIC's Family Assistance Plan and numerous low-cost interexchange rate plans. They note that MCI offers some of the lowest intrastate toll rates in California. MCIC has also aggressively pursued the Hispanic market throughout the US and especially in California. And, MCIC sales and service efforts are bilingual, as are all fulfillment and customer communication materials. MCIC has also engaged in numerous educational and community relations programs that benefit the Hispanic community.

Applicants contend that hearings are unnecessary, and that none of the protestants has demonstrated that an evidentiary hearing is necessary to resolve factual disputes.

B. Reply to Amended Protest

Applicants believe all issues related to the antitrust implications of the merger on the internet are before the FCC and that the Commission should defer to this federal agency on this aspect of the merger. They observe that the internet has grown entirely in the competitive environment, unfettered by government regulation. This is reflected in the Telecom Act's Section 230(b)(2)'s policy statement about preservation of the vibrant and competitive free market existing for the internet. Applicants assert that the demand for internet services more than doubles each year and the number of ISPs in North America has tripled in 20 months. Applicants contend that control of the MAEs has nothing to do with the merger, since WCOM owns them, not MCIC. They argue the merger will not be a barrier to entry, especially in light of GTEC's recent campaign to develop a fiber data network and recent investments in BBN Corporation and agreement to buy 25% of Qwest's fiber optic network. Applicants believe that the wide availability of underlying transmission facilities and commonly available routers, switches, and modems which make up internet backbones preclude any competitive threat from the merger. Applicants then incorporate by reference comments to the FCC on the antitrust aspects of the merger.

VI. The Co-Assigned Commissioners' Ruling

On May 21, 1998, the two Co-Assigned Commissioners in this application issued a Ruling (CACR) resolving the procedural treatment of this application by the Commission.

The CACR noted that in D.97-05-092, the Commission, pursuant to its authority under PU Code § 853(b) and § 854(a), granted the BT/MCIC application an exemption from compliance with PU Code §§ 854(b) and (c) because such compliance was not necessary in the public interest based on the specific facts and circumstances before the Commission. In that decision, the Administrative Law Judge (ALJ) was directed to process the application under PU Code § 854(a). In D.97-05-092, the Commission also requested the AG's opinion on the antitrust aspects of the change in control. However, the Commission stated it was not requesting that opinion under PU Code § 854(b)(3). Instead, the antitrust analysis used under PU Code § 854(a) was to be employed.

The CACR also observed that in D.97-07-060, the Commission approved ex-parte the application for change in control of MCIC to BT as being in the public interest under PU Code § 854(a). However, due to antitrust implications of the merger in the international cable markets, the Commission declared that, within 30 days of the FCC order on the proposed BT merger, the Commission could consider whether to reopen the proceeding if the FCC did not institute appropriate anti-competitive safeguards.

The CACR dealt with the applicants' requests that the change in control application of MCIC and WCOM be treated in the same manner as the previous application for control of MCIC by BT. After an analysis of the gravamen of the protests and the replies thereto, the Co-Assigned Commissioners found that the record placed before the Commission was sufficient to render the appropriate Commission decision on the MCI/WCOM application ex parte under PU Code § 854(a). The Co-Assigned Commissioners declared that they had sufficient Commission guidance to follow in making their procedural decision, through not only D.97-05-092 and D.97-07-060, but also D.98-05-022 (issued May 7, 1998), in which the Commission granted the application of AT&T Corp. (AT&T) to acquire control of Teleport Communications Group, Inc. (TCG) under PU Code § 854(a) with an exemption from scrutiny under PU Code § 854(b) and (c). In today's decision before the entire Commission, we reiterate and adopt the reasoning of the CACR in reaching this conclusion.

As recognized in D.98-05-022, in the Commission's decision to exempt the BT/MCIC merger from PU Code § 854(b) and (c), the Commission looked to three basic principles developed in D.97-05-092. First, in both the BT/MCIC and AT&T/TCG mergers, the Commission noted that the application did not involve putting together two traditionally regulated telephone systems.[4] The instant application meets this criterion. Both MCIC and WCOM operate in the local and long distance markets as CLECs and nondominant interexchange carriers

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[4] While AT&T was once more heavily regulated as a dominant carrier, by the time of the TCG merger we had accorded it nondominant status.

(NDIECs). As in the BT/MCIC and AT&T/TCG mergers, the acquisition of a heavily-regulated local exchange carrier is not the reason for the instant merger.

Second, in the BT/MCIC merger, MCIC, the acquired company, was an NDIEC and CLEC over which the Commission has forborne from exercising the type of ratemaking authority that is contemplated by PU Code § 854(b).[5] The instant application meets this criterion. Not only are MCIC and WCOM both NDIECs, they also operate as CLECs which are not subject to the same degree of rate regulation as are incumbent local exchange carriers. The internet services of WCOM and MCIC are offered in an arena generally unregulated by this Commission or any other State or Federal regulatory body.[6] Therefore, in the instant application, as in the BT/MCIC and AT&T/TCG mergers, the Commission does not exercise the ratemaking authority referenced in § 854(b) to jurisdictionally permit the Commission to allocate benefits from the merger to ratepayers.

Third, in both the BT/MCIC and AT&T/TCG mergers, the Commission recognized that the requirements of PU Code § 854(b)(1) and (2) for a finding of merger benefits and an allocation of a portion to ratepayers did not fit MCIC and TCG, respectively, each of which had grown under competitive forces at the sole risk of its shareholders without a captive ratepayer base and monopoly franchise to buffer risk and reward. This criterion is still met by MCIC in the instant application. We believe that the instant application fits the Commission's criteria

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[5] PU Code § 854(b)(2) requires the Commission to equitably allocate, where the Commission has ratemaking authority, the total short-term and long-term forecasted economic benefits of the proposed merger between shareholders and ratepayers, with ratepayers receiving not less than 50% of those benefits.

[6] We acknowledge that the FCC is currently looking at certain access charge issues in relation to internet services.

for an exemption from the requirements of PU Code §§ 854(b) and (c) pursuant to the Commission's authority under PU Code § 853(b). We concur with the Co-Assigned Commissioners that established Commission policy permitted the CACR setting the procedure to be followed thereunder and that an interim decision before the entire Commission was not necessary so to do.

We believe that the CACR and today's decision also follow Commission precedent, set in D.97-05-092, that to subject the instant transaction to extensive regulatory review, when no ratemaking scheme extends over the parties to permit the Commission to allocate benefits, would stifle competition and discourage the operation of market forces. As the Commission noted in the BT/MCIC merger opinion:

> "In our view, this goes against the main thrust of the Telecommunications Act of 1996 and our telecommunications policy to open the field to competitive forces for the benefit of consumers. For this reason, competitive market forces rather than mandated rate reductions, will distribute any benefits of the merger to MCI ratepayers." (D.97-05-092, mimeo., p. 20.)

In today's final decision on this merger, § 853(b) empowers the Commission to impose any requirements deemed necessary to protect customers or subscribers. We have today also considered the merits of the protests. We concur with the CACR that no disputed facts were identified by protestants that require a hearing under PU Code § 854(a).

We approve the CACR's request of the AG's opinion regarding the antitrust implications of this merger under § 854(a), as the Commission did in D.97-05-092. That antitrust opinion is now part of the record before the Commission and is discussed infra.

We find that the CACR gave due regard to the Commission's express policy to grant § 853(b) exemptions from § 854(b) and (c) to merger transactions involving nontraditionally regulated carriers on a case-by-case basis only. In approving the CACR, we reiterate that while there may be much merit to the consideration of a blanket exemption from PU Code § 854(b) and (c) for NDIECs, no such blanket exemption has been granted.[7]

In conclusion, we affirm the CACR's ruling that this application falls within the Commission's criteria, established in D.97-05-092, D.97-07-060, and D.98-05-022 for an exemption under the PU Code § 853(b) from scrutiny under PU Code § 854(b) and (c) and the CACR's direction to the ALJ, in consultation with the Co-Assigned Commissioners, to process this application on an ex parte basis under PU Code § 854(a).

Discussion

VII. Determination of the Public Interest

As we stated in D.97-07-060, PU Code § 854(a) declares that no person or corporation shall merge, acquire, or control, either indirectly or directly, any public utility organized and doing business in California without first securing our authorization. Under this section "the primary question to be determined in a transfer proceeding is whether the proposed transfer would be adverse to the public interest. Questions relating to public convenience and necessity usually are not relevant to the transfer proceeding because they were determined in the proceeding in which the certificate was granted." (M. Lee (Radio Paging Co.), 65 CPUC 635, 637 (1966) (citations omitted).) We have had a long standing Commission policy forbidding re-litigation of public convenience and necessity issues in transfer applications due to our recognition that such contests are likely

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7 See Footnote 2 at p. 11 of D.98-05-022 for a discussion of how the Advice Letter procedure applicable to NDIEC and certain CLEC acquisitions interfaces with transactions seeking a PU Code § 853(b) exemption.

to be profoundly anti-competitive, lead to long delay, and rarely present a good balanced record on the merits of increased or decreased competition in any particular market. (BellSouth Corporation, D.86-12-090, 23 CPUC2d 82 (1986), 1986 Cal.PUC LEXIS 852, 859.) Thus we carry out our sua sponte responsibility to insure that our proceedings are not abused by regulated companies as a means to destroy or harass competitors. (Id.)

A. Public Interest Factors

As we discuss infra, antitrust considerations are relevant to our consideration of the public interest. (M. Lee (Radio Paging Co.), 65 CPUC at 637 n.1.) In transfer applications we also require an applicant to demonstrate that the proposed utility operation will be economically and financially feasible. (R.L. Mohr (Advanced Electronics), 69 CPUC 275, 277 (1969). See also, Santa Barbara Cellular, Inc., 32 CPUC2d 478 (1989).) Part of this analysis is a consideration of the price to be paid considering the value to both the seller and buyer. (Union Water Co. of California, 19 CRRC 199, 202 (1920).) We have also considered efficiencies and operating cost savings which should result from the proposed merger. (Southern Counties Gas Co. of California, 70 CPUC 836, 837 (1970).) Another factor is whether a merger would produce a broader base for financing with more resultant flexibility. (Southern California Gas Co., 74 CPUC 30, 50, modified on other grounds, 74 CPUC 259 (1972).) As noted in Union Water Co.:

> "The Commission is primarily concerned with the question of whether or not the transfer of this property from one ownership to another...will serve the best interests of the public. To determine this, consideration must be given to whether or not the proposed transfer will better service conditions, effect economies in expenditures and efficiencies in operation." (Id. at 200.)

We have also ascertained whether the new owner is experienced, financially responsible, and adequately equipped to continue the business sought to be acquired. (City Transfer and Storage Co., 46 CRRC 5, 7 (1945).) We also look to the technical and managerial competence of the acquiring entity to assure customers of the continuance of the kind and quality of service they have experienced in the past. (Communications Industries, Inc., 13 CPUC2d 595, 598 (1983).) Finally, as we did in D.97-07-060, we will assess the relevant factors under PU Code § 854(c) in our analysis of the public interest.[8] However, outside the mandates of that statute, consideration of public interest factors must have some nexus to rates and service in order to pass muster under the doctrine prohibiting our unnecessary intermeddling by invasion of management. (See, Stepak v. AT&T, 186 Cal.App.3d 636, 231 Cal.Rptr. 37 (Cal.App. 1st Dist. 1986); Pacific Telephone & Telegraph Co. v. Public Utilities Commission, 34 Cal.2d 282, 215 P.2d 441 (1950).) After our assessment of public interest is made, we may impose any necessary conditions on a transfer. (Outingdale Water Co., 70 CPUC 639, 640-41 (1970).) Additionally, although we have granted the applicants an

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[8] Public interest factors enumerated under PU Code § 854(c) are whether the merger will: (1) maintain or improve the financial condition of the resulting public utility doing business in California; (2) maintain or improve the quality of service to California ratepayers; (3) maintain or improve the quality of management of the resulting utility doing business in California; (4) be fair and reasonable to the affected utility employees; (5) be fair and reasonable to a majority of the utility shareholders; (6) be beneficial on an overall basis to state and local economies and communities in the area served by the resulting public utility; and (7) preserve the jurisdiction of the Commission and our capacity to effectively regulate and audit public utility operations in California.

exemption from application of PU Code §§ 854(b) and (c), we may impose any conditions deemed necessary under the statutory power of PU Code § 853(b).[9]

B. Analysis of Public Interest Factors

A review of the financial data from applicants discloses that the merger is economically and financially feasible. We reject TURN's contention that the cost of the merger weakens the combined company's financial position. In this acquisition, MCIC gets the benefit of WCOM's facilities-based local network, enabling both companies to be stronger competitors in serving local markets. Though the total price is high and the termination payment to BT substantial, a review of the financial information contained in the Securities and Exchange Commission (SEC) Form S-4 and Form 10Q of WCOM, Form 10Q of MCIC and the pro forma balance sheet attached as Exhibit G to the application discloses that the applicants' current financial strength and projected revenues from the synergies of the combined companies make this merger financially prudent. We concur with applicants that we should not second guess the Board

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[9] PU Code § 853(b) declares that:

> "The Commission may from time to time by order or rule, and subject to those terms and conditions as may be prescribed therein, exempt any public utility or class of public utility from this article if it finds that the application thereof with respect to the public utility or class of public utility is not necessary in the public interest. The Commission may establish rules or impose requirements deemed necessary to protect the interest of the customers or subscribers of the public utility or class of public utility exempted under this subdivision. These rules or requirements may include, but are not limited to, notification of a proposed sale or transfer of assets or stock and provision for refunds or credits to customers or subscribers."

of Directors of both companies who in the discharge of their fiduciary duties have approved the merger financing. We also note two fairness opinions by investment banking firms support the transaction.

We find the merger to be both strategically and financially prudent. Both applicants are fiscally healthy, and the combined financial strength of WCOM and MCIC will increase their access to capital and lower its cost. The merger will give the combined companies enhanced capabilities in the form of capital, marketing ability and state-of-the-art networks and will thus increase their ability to compete effectively in California, nationwide and globally. Our review of the price paid for the shares leads us to conclude it is fair and reasonable considering the value to both WCOM and MCIC shareholders. The applicants project annual cash operating cost synergies of $2.5 billion in 1999, increasing to $5.6 billion by 2002. Capital expenditure savings of $2 billion a year are expected in 1999 and beyond. We find that these efficiencies and operating cost savings will accrue through the combination of WCOM and MCIC's networks and telecommunications expertise. Access to more financing at lower costs at a time when both applicants are trying to improve infrastructure and technology while operating in competitive global markets is likely to lead to better service conditions for MCIC's and WCOM's California ratepayers.

We concur that the consolidation of WCOM's skills and experience in building and operating local exchange communications networks with MCIC's sales and marketing expertise will enhance each applicant's competitive ability. We agree that this will permit the combined companies to compete vigorously in the local exchange service market. The increased efficiencies of the combined companies will permit increased expansion of state-of-the-art networks and accelerate the introduction of new broadband and advanced data communications services and products. This in turn will expand California consumers' choices. This has always been our intent in fostering competition in California telecommunications markets.

Applicants aver that one of the principal reasons for this merger is to enhance their ability to offer consumers a total package of local, long distance, international, and internet services. Because MCIC already has a strong, nationwide base of millions of residential customers for long distance, the merged company has the incentive to offer them a total package of services on one bill. The combined companies also want to expand MCIC's current local service offering to attract more customers to whom they can then sell packages of services. We concur with the applicants that the efficiencies and savings the merger will engender will permit services to be expanded at less net cost and that the combined companies have every business incentive to do so. We will hold applicants to their pledge to strongly enter the residential and small business local service market as soon as market conditions allow. As a result of our § 271 collaborative proceeding, we think that will occur rapidly.

We do not share CWA's, TURN's, or ORA's fears that the combined companies will serve only the business sector. We have carefully considered the conditions that ORA believes should be placed on our approval to ensure this commitment to the residential local exchange market. However, we cannot substitute our business judgment for that of the applicants' management in deciding whether to enter or leave markets. The level of competition in the residential local exchange market has been disappointing to us, but we believe that regulatorily and operationally this Commission and market participants are working out the barriers to entry. The applicants have made a commitment in their filings. Rule 1 requires they not mislead us in this regard. Therefore, at this juncture we will not require applicants to not abandon residential local service in any existing California market or to undergo the extensive post merger monitoring ORA desires.

We believe the combination of services the combined company will provide and the advanced technology it will be able to deploy will inure to the benefit of all California consumers. Enhancing MCIC's competitive position with WCOM's expertise and financial standing will be likely to increase competition in the local telecommunications market, which furthers this Commission's policies to promote competition. In addition, the affiliation with WCOM's cellular and paging interests will enhance service on a global scale to California wireless customers. Global product development and marketing of global services will make California businesses better able to compete in international markets. Without question, WCOM, as the new owner, is experienced, financially responsible, and more than adequately equipped to continue MCIC's business.

We reject CWA's argument that universal service support will be undermined by the merger to the detriment of local service. Both the FCC and this Commission have switched from implicit universal services subsidies to explicit subsidies. Therefore, the feared diversion of funds should not occur.

Looking to relevant PU Code § 854(c) factors, we have already concluded that the merger will improve the financial condition of the acquired MCIC and the quality of service to California ratepayers. We find that the merger will maintain the quality of management of the California-certificated MCIC and WCOM subsidiaries. We also find that the merger is fair and reasonable to affected utility employees due to the applicants' projected 20% revenue growth post merger which will foster new employment opportunities post merger as a result of the combined companies' synergies and increased competitive ability. To the extent that the utility assets are being transferred at a fair price, we conclude that the merger is fair and reasonable to the majority of each applicant's shareholders due to the value-based price of the acquired corporation and the fact a majority of shareholders have approved the merger. The merger will also be beneficial overall to state and local economies and communities in the area served by MCIC and WCOM by virtue of the commitment to advanced technologies and increased service offerings, MCIC's Family Assistance Plan (FAP) and numerous low-cost interexchange rate plans, MCIC's efforts in the Hispanic market and the combined presence of MCIC and WCOM offices in California communities. We find that our jurisdiction is preserved, and we will maintain our capacity to effectively regulate and audit MCIC's and WCOM's operations in California. Thus, all PU Code § 854(c) criteria are met.

VIII. Antitrust and the Public Interest

The final part of our public interest analysis concerns antitrust considerations. (M. Lee (Radio Paging Co., supra at 640.) The Commission must take into account the antitrust aspects of applications which are before it. (Northern California Power Agency v. Public Utilities Commission, 5 Cal.3d 370, 379, 96 Cal.Rptr. 18, 486 P.2d 1218 (1971).) "By considering antitrust issues, the Commission merely carries out its legislative mandate to determine whether the public convenience and necessity require a proposed development. That task does not impinge upon the jurisdiction of the federal courts in federal antitrust cases. . . . The Commission may approve projects even though they would otherwise violate the antitrust laws; it may also disapprove projects which do not violate such laws. Its consideration of antitrust problems is for purposes quite different from those of the courts; it does not usurp their function." (Id. at 378.) See also, Industrial Communications Systems, Inc. v. Public Utilities Commission, 22 Cal.3d 572, 150 Cal. Rptr.13, 585 P.2d 863 (1978); Northern Natural Gas Co. v. Federal Power Commission, 399 F.2d 953, 958 (DC Cir. 1968). Under Northern

California Power Agency, we are required to consider sua sponte every element of the public interest affected by our approval, including economic and competitive aspects. See also, U.S. Steel Corp., 29 Cal.3d 603, 608, 175 Cal. Rptr. 169, 629 P.2d 1381 (1981); City of Los Angeles v. Public Utilities Commission, 15 Cal.3d 680, 694, 125 Cal.Rptr. 779, 542 P.2d 1371 (1975). However, Northern California Power Agency requires consideration of antitrust issues where a close nexus exists between the matter to be approved and any agreement presenting antitrust problems, not when the antitrust implications have only tangential impact on the primary matter before the Commission. (Industrial Communications Systems, Inc., 22 Cal.3d at 582.) When alternatives with different economic effects are presented to the Commission, we must consider the alternatives and the factors warranting the adoption of those alternatives if the economic effects of the application are material to the exercise of the Commission's discretion. (U.S. Steel Corp., 29 Cal.3d at 608-609.) "A clear line of cases specifies that competition is one of the factors bearing on the exercise of this Commission's discretion, and is one of the factors that must be considered in its decision-making process. This is true regardless of whether the effect is intrastate as in Industrial Comm. Systems, interstate as alleged in Northern California Power Agency, or foreign as in U.S. Steel." (Application of SCEcorp, 40 CPUC2d 159, 179 (1991) (citations omitted, footnote omitted).)

Our task is to balance any anti-competitive effects of the merger against the benefits of the merger to see if anti-competitive effects are outweighed by the merger's benefits, therefore making the merger consistent with the public interest. (Pacific Southwest Airlines, 75 CPUC 1, 19 (1973).) We are not strictly bound by the dictates of the antitrust laws, for we can approve actions which violate antitrust policies when other economic, social, or political considerations are found to be of overriding importance. SCECorp, 40 CPUC2d at 179. We need not choose another course of action if our proposed course has anti-competitive effects, as long as our course of action is in the public interest. (Pacific Gas & Electric Co., D.93-02-018, 48 CPUC2d 162 (1993); 1993 Cal. PUC LEXIS 275, 282.)

A. The EC's Approval

On July 8, 1998, the European Commission (EC) conditionally approved the merger, subject to the divestiture of MCIC's entire wholesale and retail internet business. WCOM's UUNet was not required to be divested. The EC did not consider competitive concerns outside the internet services market.

B. The US DOJ's Approval

On July 15, 1998, the DOJ's Antitrust Division issued its approval of the merger, but placed conditions on the combined companies to prevent anticompetitive consequences in the internet markets. After reviewing the terms of a proposed sale of all of MCIC's internet assets, the DOJ concluded that the divestiture would resolve the DOJ's competitive concerns about the merger. The DOJ also agreed that UUNet need not be divested. No conditions were placed upon long distance markets.

C. The Pending Sale of All of MCIC's Internet Assets

On July 15, 1998, MCIC filed its Reply Comments of MCI Concerning Divestiture of its Internet Business (Reply Comments) with the FCC in CC Docket No. 97-211. We take official notice of these Reply Comments under Rule 73 of the Commission's Rules of Practice and Procedure (Rules). In the Reply Comments MCIC declared that, after the EC and DOJ conditioned their approval of the proposed merger on divestiture of MCIC's retail and wholesale internet operations, MCIC entered into an agreement with Cable & Wireless plc (CW). Under the divestiture agreement, MCIC will transfer all of the physical assets which comprise its internet backbone to CW. MCIC will provide the right to use the transmission capacity that CW needs to operate the network, including projected growth requirements, the right to use all associated dedicated software and operations support systems, the assignment of all internet addresses used in the transferred business and collocation rights permitting CW to maintain equipment in MCIC facilities. MCIC will transfer to CW all engineering, sales, customer service/telemarketing, managerial, financial and administrative employees necessary to operate the business. MCIC will lease transmission capacity to CW on competitive commercial terms for a minimum of two years, with an option to extend for an additional three years. MCIC will also transfer to CW all of the peering agreements to which MCIC is a party. CW's current peering agreement with MCIC will be extended on a long-term basis. MCIC will transfer to CW its contracts with ISPs, and CW will replace MCIC as the provider of backbone services to them. MCIC will transfer to CW its contracts with retail customers for internet service as well as web-hosting, managed firewall and Real Broadcast Network services. The combined company has agreed to refrain from soliciting customers back for a period of 18 months for internet service and 6 months for the three other services. CW will pay MCIC $1.75 billion in cash at closing. Closing of the divestiture agreement is conditioned upon the instant proposed merger proceeding. FCC approval of the divestiture agreement is not required. The sale will close contemporaneously with or prior to the WCOM/MCIC merger.

D. Comments of the Attorney General of California

On July 24, 1998, Comments of the Attorney General of California on Proposed Merger (Comments) were filed. In the Comments the AG noted that the merger had been reviewed on an expedited basis without the benefit of a complete record.[10] In summary, the AG concluded that:

> "Although this transaction will significantly increase concentration within the market for bulk long distance services, we conclude that the merger should not adversely affect California consumers within those markets. The applicants are two of the four largest interexchange carriers, but at least seven well-financed suppliers with national networks - including Points of Presence (POPS) in Los Angeles, San Francisco, Sacramento, and San Diego -- will compete for California long distance sales following the merger. Moreover, prices within the industry have steadily declined over the past ten years, while output has increased and entry has remained substantial. In addition, the surviving firm will remain less than half the size of AT&T, which has announced its own plans to merge with TCI.
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> "Both firms are also leading suppliers of internet backbone services. To eliminate antitrust concerns of the United States Department of Justice, MCIC has agreed to divest all of its wholesale and retail internet operations. That divestiture completely moots any questions about whether the merger will have anticompetitive effects upon internet markets. In addition, we conclude that the merger will not have a significant effect in local markets, where incumbent carriers still provide the vast majority of access and other network services. We have no opinion on whether the merger will adversely affect competition in international markets, including those between the U.K. and California; however, even implicitly alleged competitive injuries are relatively small." (Comments of the Attorney General , mimeo. at 1-2.)

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[10] Due to the expedited review, the time constraints prevented the AG from commenting on the CACR's request for permission to defer to the FCC's antitrust analysis on interstate and international issues .

The AG noted that the proposed merger would unite the second and fourth largest suppliers of bulk long distance services in the U.S. and that the applicants are the leading suppliers of internet backbone services. The AG found that MCIC has firmly established itself as the second largest carrier in virtually all long distance markets relevant to this proceeding. In 1995, MCIC generated toll service revenues of $12.9 billion from U.S. operations, representing 17.8 percent of industry long distance revenues. MCIC is the second leading supplier, behind AT&T, in each of those markets. In 1995, AT&T had revenues of $38 billion and a 53% market share in the U.S. long distance market and $5.7 billion and a 62% market share from international services.

The AG found that MCIC is also rapidly entering major local markets, including Los Angeles, San Francisco, and San Diego. Before the end of 1996, the company had established 80 operational local city networks in 39 cities. In 1997, MCIC generated $343 million from local service revenues. MCIC's local networks now cover more than 3,600 route miles nationwide. MCIC is also a major supplier within the U.S. cellular and other wireless markets.

As to WCOM, the AG observed that it is a leading supplier of long distance, internet and competitive access services. WCOM obtained much of its national, facilities-based long distance network by acquiring WilTel Network Services in 1995. Similarly, WCOM obtained many of its internet and local service facilities through its 1996 purchase of MFS Communications, a major competitive access provider (CAP) and owner of the world's largest ISP, UUNet.

WCOM has not actively marketed its long distance services to residential customers, but it is a leading supplier of wholesale long distance services to large business customers and resellers. Since 1996, WCOM has provided wholesale services to GTE, Ameritech, and SBC Mobile Systems. WCOM now has approximately five percent of national interexchange revenues.

Under the DOJ/Federal Trade Commission (FTC) Merger Guidelines (Merger Guidelines), the AG conducted a full analysis of the competitive effects. The AG noted that the traditional antitrust model assesses the competitive effects of a merger within a "relevant market," which exhibits both product and geographic dimensions. Under the Merger Guidelines, the effects of a "horizontal" merger depend upon several related factors, which include changes in concentration levels within the relevant market, as well as entry conditions and efficiency enhancements. We reproduce below verbatim, the AG's analysis.

> "A. General Considerations
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> "The relevant product refers to the 'horizontal' range of products or services that are or could be easily made relatively interchangeable, so that pricing decisions by one firm are influenced by the range of alternative supplies available to the purchaser. The substitutes comprising the product market can be differentiated, at least to some extent. Thus, carriers providing long distance services within the same region may offer different billing, operator, and other enhanced services, but their services are still in the same product market because they are such close substitutes.
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> "The relevant product also has a vertical dimension. In theory, the horizontal and vertical dimensions of the relevant market are 'immaterial.'[11] In fact, however, empirical limitations require a 'noticeable' 'gap in the chain' of complements (as well as substitutes)[12] In their

[11] OLandes and Posner, Market Power in Antitrust Cases, 94 Harv. L.Rev. 937, 978 (1981).

[12] Schmalensee, On the Use of Economic Models in Antitrust: The ReaLemon Case, 127 U.Pa.L.Rev. 994, 1010 (1979).

Horizontal Merger Guidelines, the National Association of Attorneys General implicitly define the vertical extent of the relevant product as the product produced in common by the merging parties.[13]

"Similar considerations govern the delineation of the relevant geographic market. The relevant geographic market is defined as the area in which sellers compete and in which buyers can practicably turn for supply.[14] In any market, the relevant geographic market will include all supplies whose prices remain closely linked, after transportation and other transaction costs are accounted for. Thus, two locations are in the same market if the differential between their prices remains 'less than the potential wedge created by arbitrage costs.'[15] Accordingly, '[p]rice relationships are clearly the best single guide to geographic market definition.'"[16]

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[13] See National Association of Attorneys General, Horizontal Merger Guidelines, 3.1 (1993), reprinted in 64 Antitrust & Trade Reg. Rep. (BNA) No. 1608 (Special Supp.); U.S. v. Waste Management, Inc., 743 F. 2d 976, 979-980 (7th Cir. 1984). See also Areeda & Turner, Antitrust Law 1525a ("A market thus includes producers of identical products, of products with physical or brand differences entirely disregarded by consumers, and of products regarded by consumers as such close substitutes that a slight relative price change in one will induce intolerable shift of demand away from the other.")

[14] U.S. v. Connecticut National Bank, 418 U.S. 656, 668 (1974). See also Stigler and Sherwin, The Extent of the Market, 28 J.L.Econ. 555, 556 (1985) "[T]he market area embraces the buyers who are willing to deal with any seller, or the sellers who are willing to deal with any buyer, or both.").

[15] Spiller and Huang, On the Extent of the Market: Wholesale Gasoline in the Northeastern United States, 35 J. Ind.Econ. 131, 133 (1985). Spiller and Huang note: "Arbitrage costs, however, do not necessarily separate producers in different markets. Consider the case of two different geographic regions with one continuously exporting to the other. Prices will differ exactly by the arbitrage costs, and the two regions will be in the same economic market." (Id. at 133 n.7.)

[16] Areeda & Turner, 2 Antitrust Law ¶522a.

"B. The Relevant Interexchange Service Markets

"The relevant market for analyzing this merger is bulk long distance services offered by facilities-based carriers and resellers throughout the United States. These, in fact, are the services that the applicants 'produce in common.' Some facilities-based carriers, such as AT&T, MCI, and Sprint, essentially transfer bulk services to their marketing divisions for resale to consumers. Others, such as WorldCom, have a very limited presence in the retail market and, for the most part, limit their sales to large business customers and resellers. Resellers also sell bulk services to each other and to large business customers. Thus, bulk services, which are an input to suppliers in the retail market,[17] are supplied by producers which are either fully or partially integrated, as well as by resellers.[18] The relevant product market includes all such sources of Supply.[19] Because the resale market for these services is highly active, the relevant geographic market is the entire United States.

"Within this relevant market are all long-distance services under the control of facilities-based carriers and resellers. AT&T, for example, would respond to a hypothetical price increase in the wholesale sector by diverting resources from its massmarketing or other divisions. Thus, the entire capacity of the AT&T, MCI, Sprint, and WorldCom networks less their long-term[20] contractual obligations to resellers and other lessees

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[17] See Declaration of Jerry A. Hausman, at ¶30. [FCC Sept. 26, 1997.]

[18] See Bower, Complementary Inputs and Market Power, 31 Antitrust Bull. 31, 59-64 (1986).

[19] See Coast Cities Truck Sales, Inc. v. Navistar International Transportation Co., 912 F.Supp. 747, 768 n.9 (D.Ct.N.J. 1995).

[20] The Merger Guidelines apparently assume that commitments of more than two years are "long term."

> would be included. Attributable to GTE would be capacity purchased on the Qwest network[21] along with lease arrangements it has made as a reseller. Also included would be bulk sales made by recent facilities-based entrants, such as Qwest, IXC, Frontier, and LD.[22]
>
> "This relevant bulk market differs significantly from those proposed by the applicants and GTE. The applicants submit that the relevant product is 'all interstate, domestic, interexchange services . . . with no relevant submarkets.'[23] GTE quotes similar language in its Petition to Deny, but later contends that this merger must be assessed in 'both wholesale (input) and retail markets.'[24] We view all of these proposed markets as unhelpful to the analysis of this merger.
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> "Focusing upon wholesale services is misleading because it fails to account for supply substitutability between different types of long distance services.[25] GTE

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[21] See Second Declaration of Dennis W. Carlton and Hal S. Sider, at ¶43 (F.C.C. Mar. 19, 1998) ("Carlton and Sider Second Declaration").

[22] Presumably, GTE would contend that only sales by the Big Three and WorldCom should be included because only their (a) networks have national coverage, (b) services are primarily "on-net," and (c) networks can be integrated with the services of other vendors.

[23] Applicants' Second Joint Reply, at 2.

[24] Id. at 25. See also Harris Long-Distance Reply Affidavit, at ¶10 ("Separate wholesale and retail product markets").

[25] In their briefs, the applicants also reject wholesale long distance services as a relevant product. Their experts Carlton and Sider, however, focus much of their analysis on wholesale suppliers without explicitly rejecting the GTE formulation of the relevant product. See, e.g., Carlton and Sider Declaration, at § III ("Long Distance: It is Highly Unlikely that the Proposed Transaction Will Adversely Affect Competition in the Provision of Either Wholesale or Retail Services"), Carlton and Sider Second Declaration at § IV ("The Proposed Transaction does not Significantly Reduce Competitive Alternatives for Wholesale and Retail Customers").

describes the wholesale market as 'the market in which resellers purchase long distance capacity or services from other carriers.'[26] As Professor Hall explains, however, 'The services purchased at wholesale by a switchless reseller are essentially the same service that retail customers purchase . . . . The only meaningful difference is in the nature of the marketing activity, which differs somewhat across residential customers, business customers, and price resellers.'[27] Short of that marketing activity, MCI and WorldCom are primarily in the business of supplying bulk long distance services to their customers.

"The retail product market proposed by GTE is also misleading because WorldCom is not a significant supplier of mass-merchandised long distance services. As Professor Hall observes, GTE essentially alleges that the merged entity will have an incentive to 'price squeeze' its competitors in the retail market,[28] as we discuss below. Nonetheless, GTE also contends that increased concentration in the retail market (calculated from company revenue figures) will adversely affect competition there, even though there is no evidence that WorldCom is a significant competitor in the retail market.

"In fact, WorldCom 'currently does no advertising directed at California residential customers, and does no direct mail or telemarketing to California residential customers.'[29] GTE Expert Robert Harris represents long

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[26] Affidavit of Richard Schmalensee and William Taylor on behalf of GTE, at $37 (F.C.C. March 13, 1998) ("Schmalensee and Taylor Affidavit").

[27] Declaration of Robert E. Hall, at ¶7 (F.C.C. January 26,1998) ("Hall Declaration").

[28] See Reply Declaration of Robert E. Hall, at ¶3 (July 1, 1998)("Hall Reply Declaration").

[29] Letter from Eric A. Artman (WorldCom Vice President) to J. Lindsay Bower, at ¶2 (July 3, 1998).

distance as a combination of three activities: transport, network services, and retailing.[30] AT&T, MCI, and Sprint are 'integrated producers' because they purchase few of those services from outside suppliers. Harris describes WorldCom, which supplies most of its own transport and network services, as a 'wholesale carrier' because it 'relies much more heavily on bulk sales to resellers.'[31] GTE expert Schmalensee and Taylor and Applicants' expert Hall describe WorldCom similarly.[32] All these experts apparently agree, however, that the overlap in offerings supplied by the applicants is in transport and network services.

"IV. The Competitive Effects

"Mergers are generally categorized as 'horizontal,' 'vertical,' or 'conglomerate.' The competitive effects of a merger are assessed by first defining the relevant markets and then determining whether the merged entity will have an enhanced ability to profitably skew price or output from competitive levels.[33]

"Under the DOJ/FTC Guidelines, the effects of a 'horizontal' merger depend upon several related factors, including changes in concentration levels, entry conditions, and efficiency enhancements. The government's vertical merger guidelines 'recognize only

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[30] Harris Long-Distance Affidavit, at ¶17 (June 6, 1998).

[31] Id. at 6.

[32] See Reply Affidavit of Richard Schmalensee and William Taylor on behalf of GTE, at ¶¶124-25 (F.C.C. June 9, 1998) ("Schmalensee and Taylor Reply Affidavit"); Hall Reply Declaration, at ¶18 ("Mass marketing involves distinct expertise and capability that some carriers, such as WorldCom, have chosen not to develop or to develop only to a limited extent.")

[33] See U.S. v. Connecticut Nat'l Bank, 418 U.S. 656, 669 (1974).

three possible anticompetitive effects: that vertical mergers might create entry barriers, facilitate horizontal coordination,or allow a regulated firm to evade rate regulation.'[34]

"A. Horizontal Effects

"The overriding result of this merger will be the 'horizontal' consolidation of the long distance operations of WorldCom and MCI. The Merger Guidelines assume that a rebuttable presumption of illegality arises when a consolidation increases the Herfindahl Hirschman Index (HHI) by more than 50 points in a 'highly concentrated' market.[35] The Guidelines view concentration data as only a 'starting point' for merger analysis,[36] however, and require reviewing agencies to also consider a variety of other factors which would affect competitive conditions within the relevant market. These include: ease of entry (§ 3), efficiencies (§ 4), the effect of the merger on coordinated interaction (§ 2.1), conditions conducive to detecting and punishing deviations (§ 2.12). In this case, we conclude that although the bulk market is highly concentrated, bulk rates are competitive and the merger will not adversely affect competition within that market.

"1. Concentration Levels

"Despite our repeated requests, the applicants have not provided data from which we could calculate concentration levels within the bulk capacity market. We believe, however, that it is reasonable to assume

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[34] Areeda and Hovenkamp, Antitrust Law, § 1015.1 (1997 Supp.).

[35] Merger Guidelines, at § 1.51(c).

[36] See Merger Guidelines, at § 2.0.

concentration levels within that market are between the 3,054 figure calculated for the retail market by Professor Harris[37] and the 2,946 figure calculated for the long-haul fiber capacity market by Professor Hall.[38] Both of those alternative methods of calculation show that the merger will increase concentration by more than 300 points.[39] The Merger Guidelines require a full analysis where such increases occur within a 'highly concentrated' (HHI above 1,800) market.

"Concentration statistics, however, are only one of many indicia of competitiveness and must be applied cautiously. Even in the simplest theoretical models, the ability of a firm to raise prices above competitive levels is as strongly related to several other factors (e.g., supply elasticity and the market elasticity of demand) as to market share.[40] Moreover, empirical studies show very weak relationships between concentration and industry performance.[41] In fact, as experts Carlton and Sider observe, industry concentration and the price of long distance services may not be related at all.[42]

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[37] Harris Long Distance Affidavit, at ¶91, Exhibit 20 (derived from toll revenues).

[38] Hall Declaration at Table 1.

[39] See Hall Declaration, at ¶25 (420 points); Harris Long-Distance Affidavit, at Table 20 (305 points).

[40] See Landes and Posner, Market Power in Antitrust Cases, 94 Harv. L.Rev. 937 (1981).

[41] See Schmalensee, Interindustry Studies of Structure and Performance, at 976 in Schmalensee and Willig, HANDBOOK OF INDUSTRIAL ORGANIZATION (1989) ("The relation, if any, between seller concentration and profitability is weak statistically, and the estimated concentration effect is usually small. The estimated relation is unstable over time and space and vanishes in many multivariate studies").

[42] Carlton and Sider Second Declaration, at ¶¶47-51.

"2. Entry

"Even in highly concentrated industries, a merger will generally not violate Section 7 if entry into the relevant market is relatively easy. In the leading case on the issue, U.S. v. Waste Management, the Second Circuit approved a merger creating a firm with a 49 percent share of the relevant trash collection market because entry 'by new firms or by existing firms . . . is so easy that any anticompetitive impact of the merger before us would be eliminated more quickly by such competition than by litigation.'[43] Where entry requires significant sunk costs, the Merger Guidelines generally view entry as 'timely' only if it occurs within two years.[44]

"The applicants and GTE have devoted considerable attention to the scale and timing of entry that could occur in response to a hypothetical price increase by the merged entity. WorldCom created its network on a piecemeal basis between 1992 and present. GTE contends that a potential supplier entering the long distance business could not meaningfully compete until it had built a new network with coverage similar to WorldCom, a process which GTE claims would take the five years it took WorldCom to grow from a $1 billion company to its current size[45] (but does not mention that WorldCom did not acquire WilTel until 1995). Thus, stressing the importance of national coverage and differentiating between carriers who have most of their

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[43] U.S. v. Waste Management, supra, at 983. See also U.S. v. FCC, 652 F.2d 72, 106 (1980) ("Freedom of entry is the single most important guarantor of competition in a concentrated industry").

[44] Merger Guidelines, supra, at § 3.2.

[45] Harris Long Distance Affidavit, at 176.

POPs 'on-net' as opposed to 'off-net,'[46] Professor Harris contends that regional carriers such as LCI and new entrants such as IXC and Qwest 'are not operating or building full national networks comparable to those of the Big Three or WorldCom.'[47] The applicants, in contrast, claim that entry is 'massive.'[48]

"Although we lack detailed information on this issue, it appears that entry by several carriers has been 'sufficient' and 'timely' within the meaning of the Merger Guidelines. As recently as 1991, the vast majority of bulk long distance communications were voice calls.[49] Since then, the demand for data transmission for internet and business applications has grown so rapidly[50] that data and voice traffic over the long distance networks are now approximately equal.[51]

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[46] See Schmalensee and Taylor Reply Affidavit, at ¶71 (discussing WorldCom's "Transcend" plan, which distinguishes between calls originating and terminating in areas where WorldCom uses its own facilities); Hall Reply Declaration, at ¶24 (arguing that Schmalensee and Taylor ignore cost considerations).

[47] Harris Long Distance Affidavit, at ¶¶51-60.

[48] Carlton and Sider Second Declaration, at ¶9. See also Hall Reply Declaration, at ¶29 ("barriers to expansion and entry are low"); Carlton and Sider Declaration, at ¶¶32-35.

[49] Huber, Kellog & Thone, THE GEODESIC NETWORK: 1993 REPORT ON COMPETITION IN THE TELEPHONE INDUSTRY, at 3.5-3.7 (1993) ("GEODESIC NETWORK II").

[50] See Hall Declaration at ¶7 ("the explosion of growth currently underway comes almost entirely from data").

[51] Kupfer, MCI WorldCom: It's the Biggest Merger Ever. Can It Rule Telecom?, Fortune, at 118 (Apr. 27, 1998). See also "Losses in Data Operations Impede Earnings Growth for GTE," San Jose Mercury News, at 7C (July 21, 1998) ("GTE data services revenues jumped to $191 million from $11 million a year earlier").

> Within five years, data is expected to account for 95 percent of total long distance traffic.[52]
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> "Response to these opportunities has included new entry as well as significant expansions in capacity and coverage by existing carriers.[53] Qwest and IXC, in fact, are each installing fiber optic networks that will increase by 35 percent the 100,000 fiber route miles already deployed throughout the United States at the end of 1996.[54] Although they do not specify when the deployment began, Carlton and Sider also claim that Qwest, IXC, and Williams 'already offer services over at least a portion of the networks and expect to complete their networks well within the two-year [Merger Guidelines] window.'[55] Qwest, whose market capitalization is almost $6 billion,[56] will soon serve nearly two million customers[57] in 125 cities (representing 80% of United States data and voice traffic).[58] In California alone Qwest, IXC, and Frontier[59] have each placed POPs in the Los Angeles, San Francisco,

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[52] Id.

[53] See Hall Declaration, at ¶7.

[54] FCC, Fiber Deployment Update, End of Year 1996. Level 3 has also announced plans to build a 20,000 mile, $3 billion network, while Williams will spend $750 million expanding its 18,000 mile network. Carlton and Sider Second Declaration, at ¶43.

[55] Carlton and Sidey Second Declaration, at ¶32.

[56] Applicants' Joint Reply, supra, at 35.

[57] Applicants' Second Joint Reply, supra, at 34.

[58] Applicants' Second Jonit Reply, supra, at 34.

[59] Harris, however, refers to these three carriers as "hybrids" because less than two-thirds of their traffic is carried entirely over their own facilities. See Harris Long-Distance Affidavit at 9-10.

Sacramento, and San Diego LATAs.[60] Cable & Wireless and GTE also have significant presences within this state.[61]

"Industry trends indicate that this entry has been competitively significant. Bell South expert Jerry Hausman reports that 'the price of bulk long distance for large volumes has decreased [during the period 1994-1997] from 4.5 cpm to about 1.3 cpm.'[62] It was during that period that Qwest, IXC, Frontier, Cable and Wireless and other firms either entered the market or initiated aggressive expansions. It is also our understanding that output in the bulk market has increased significantly, while concentration levels have declined. We conclude that any attempt by MCI WorldCom to raise bulk prices above the competitive level would be defeated by entry or expansion similar to that which has occurred during the past five years.

"3. 'Buyer Sophistication' in the Long Distance Bulk Market

"In determining the effects of a merger, the courts also consider the sophistication and bargaining power of buyers in the relevant market and whether they can effectively respond to anticompetitive price increases.[63]

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[60] Carlton and Sider Second Declaration, at Appendix 2.2.

[61] Id., at ¶43, Appendix 2.2.

[62] Declaration of Professor Jerry A. Hausman, at ¶30.

[63] See U.S. v. Country Lake Foods, Inc., 754 F.Supp. 669, 679 (D.Minn. 1990) (the "most persuasive" evidence submitted by defendant milk processors that their merger would not violate Section 7 was proof that substantial buyers "swift[ly] and aggressive[ly] responded to price increases unrelated to normal market conditions as well as their willingness to seek out suppliers who would sell fluid milk at lower prices"); U.S. v. Baker Hughes, Inc., 908 F.2d 981 (D.C.Cir. 1990).

Bulk transactions generally involve internal transfers within major facilities-based carriers or sales to resellers or large business customers. These customers are experienced, highly sophisticated purchasers with significant bargaining power. The applicants report that wholesalers have recently entered into contracts with: BellSouth, covering 39 states; Ameritech, covering 45 states; Bell Atlantic/NYNEX, covering 34 states; and SBC/Telesis, covering five states.[64] As the applicants also observe, sophisticated buyers would be likely to contest a merger that would raise industry prices, but GTE (a rejected suitor), BellSouth and Bell Atlantic (which seek entry into the long distance markets) are the only buyers protesting this transaction.[65]

"B. Vertical Effects: The GTE 'Cannibalization' Theory

"One of the most important vertical features of this merger will be the consolidation of the MCI long distance sales operations with the WorldCom network. Although vertical mergers are rarely anticompetitive,[66]

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[64] Carlton and Sider Second Declaration, at ¶64, citing Yankee Group, Telecommunication White Paper, vol. 12, no. 12 (Dec. 1997).

[65] See U.S. v. Syufy, supra, 903 F.2d at 669. See also Applicants' Joint Reply, supra, at 27 ("It is notable who has not weighed in to oppose the merger, especially -- given these petitioners' purported concerns about the competitiveness of the wholesale market -- the large number of sophisticated resellers that are both customers of and competitors to MCI and WorldCom.").

[66] Fruehauf Corp. v. F.T.C., 603 F.2d 345, 351 (2d Cir. 1979), citing R. Posner, Antitrust Law, an Economic Perspective 200 (1976). In fact, the FTC and the DOJ "appear not to have challenged a purely vertical transaction during the period from 1981-1993." Roscoe B. Starek, III, Reinventing Antitrust Enforcement? Antitrust Enforcement at the FTC in 1995 and Beyond, Remarks at "A New Age of Antitrust Enforcement: Antitrust in 1995" (Marina Del Rey, CA Feb. 24, 1995).

In general, "there is but one maximum monopoly profit to be gained from the sale of an endproduct." See Town of Concord, Mass. v. Boston Edison Co., 915 F. 2d 17, 23 (Ist

Footnote continued on next page

GTE contends that this vertical feature of the merger will raise prices because the merged entity will withdraw WorldCom resources from the wholesale market and apply them to the 'oligopolistic' retail market.[67] In fact, Schmalensee and Taylor argue, the most profitable strategy for a firm with an established marketing division, like MCI or the merged entity, would be to 'serve only the retail market.'[68] FCC resale requirements prohibit us from 'literally observ[ing] this outcome,'[69] so the merged entity will attempt to mirror the current MCI product mix.[70] As a result of this diversion, competition within the wholesale market will weaken, raising wholesale rates and reducing the ability of resellers to compete for retail customers.[71]

"While appealing at first glance, this 'cannibalization' theory relies upon questionable data, and ignores important risk considerations and certain beneficial effects that the assumed shift would have for retail consumers. As discussed by WorldCom Vice President Dennis Kolb, GTE bases the calculated incentive of MCIWorldCom to withdraw from wholesale markets upon 'a 1.5 cent per minute wholesale rate proposed by

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Cir. 1990) (noting that "several members of the Supreme Court have pointed out [this] 'widely accepted,' (albeit 'counterintuitive') economic argument"). It is for this reason that the "government's 1984 vertical merger guidelines are not concerned..... with the possible use of vertical integration to 'leverage' monopoly from one market into another." Areeda & Hovenkamp, <u>supra</u>, ¶1015.1.

[67] Schmalensee and Taylor Affidavit, at ¶56.

[68] <u>Id</u>. at ¶61.

[69] <u>Id</u>. at ¶62.

[70] <u>Id</u>. at ¶54.

[71] <u>Id</u>. at ¶¶64-65.

Sprint to one customer."[72] Relying upon the confidential information provided by Mr. Kolb in paragraph three of his unredacted affidavit, we agree that the assumed figure is unrealistically low.

"Furthermore, if Schmalensee and Taylor have correctly predicted the optimal service mix for MCIWorldCom, the merger would dramatically increase the supply of services available at the retail level, thereby reducing residential and small business rates -- regardless of whether the Big Three alter their pricing behavior. The supply available within the wholesale sector to resellers and large business would be proportionately reduced, with offsetting rate increases. It is not at all clear from the Schmalensee and Taylor analysis, however, that this reallocation of resources now held separately by MCI and WorldCom would have overall adverse effects upon consumers.

"Schmalensee and Taylor also fail to account for important relative revenue risk considerations. They assert that sales in the retail market are much more profitable than sales in the wholesale market, perhaps by a factor of ten.[73] For a firm like MCI, which has a $475 million advertising budget,[74] they argue, wholesale sales are actually unprofitable because they divert sales from the profitable retail sector. In fact, suppliers in the wholesale market contract with resellers on a bulk minute or dedicated line basis, for periods generally ranging from six months to five years. With limited exceptions, suppliers of leased lines can successfully transfer the risk of low revenues to the other party. This difference in risk may account for much, if not all, of the

[72] Affidavit of Dennis Kolb, at ¶3 (F.C.C. July 7, 1998).

[73] Schmalensee and Taylor Affidavit, at ¶61.

[74] Id. at ¶56.

> difference between retail and wholesale margins. Wholesale suppliers which contract on a per minute basis retain that risk and will, accordingly, maximize utilization on their tariffed lines.
>
> "V. Conclusion
>
> "Through this merger, the applicants are attempting to meet strong demand for one stop shopping and the rapid growth in demand or long distance data transmission services. The entity they create will be able to offer the broadest package of services available from any major carrier within the United States. We take no position on the competitiveness of retail rates, but we do not believe this merger will either raise prices or reduce output within the relevant market for bulk long distance services. We also find no probative evidence that the vertical consolidation of the MCI sales division with the WorldCom network will raise prices within that relevant market or within retail or wholesale sectors." (Comments, mimeo. at pp. 6-23 (footnotes renumbered).)

E. The Competitive Effects of the Proposed Merger

We have reviewed thoroughly the arguments of the parties and the AG's comments. We thank the AG for his careful and expedited analysis.

We concur with the AG's opinion that this horizontal combination will not have anti-competitive effects in the long distance market. Competition in this market is well established and expansions by new as well as existing entrants are happening rapidly. In addition, price competition is substantial and would prevent the combined companies from raising prices over competitive levels. We also concur that output will not be reduced.

In addition, we agree with the AG's finding that the vertical consolidation of the MCIC sales division with WCOM's network is not likely to raise prices within that relevant market or within the retail or wholesale sectors.

Since incumbent carriers provide the vast majority of access in local markets, the merger should not have a significant effect therein. We, like ORA, however, believe that this merger is likely to lead to increased competition in local markets.

As did the AG, we conclude that the planned divestiture of all of MCIC's retail and wholesale internet operations, prior to or contemporaneously with the closing of the merger, moots all antitrust issues in the internet market.

Therefore, we determine that this proposed merger will have no anti-competitive effects.

IX. California Environmental Quality Analysis

We conclude that the proposed transfer will have no adverse effect or impact on the environment because the transaction involves only the transfer of outstanding shares of MCIC stock for shares of WCOM and cash.

X. The Oral Argument

By ALJ Ruling of August 7, 1998, parties were furnished a copy of the draft decision in the proceeding for use in preparation for an oral argument. On August 24, 1998, the Commission held an oral argument in this proceeding. Only applicants, GTEC, ORA, and CWA appeared before the Commission. We have carefully considered the arguments of the parties, but decline to make substantive changes in the draft decision.

XI. Conclusion

We declare that, considering all relevant public interest factors, this merger, on balance, is in the public interest. We continue to believe that competitive market forces will distribute the benefits of this merger to MCIC's California ratepayers.

Findings of Fact

1. Applicants filed for approval of the proposed merger between MCIC and WCOM by application under PU Code § 854(a).

2. Notice of the application appeared in the Commission's Daily Calendar on December 10, 1997. The protest period expired on January 9, 1998.

3. Five protests were filed. Applicants replied to the protests. GTEC then filed an amended protest to which applicants then replied.

4. The shareholders of both corporations have approved the merger, as has the EC and the DOJ, subject to conditions. The FCC has not yet acted upon applicants' application before that agency, nor have all of the states from which approval has been sought.

5. In the CACR dated May 21, 1998, it was found that the public interest would be protected by review under PU Code § 854(a) and the Commission's power to impose any necessary requirements on the Commission's approval under PU Code § 853(b). Therefore, the Co-Assigned Commissioners granted this merger an exemption from compliance with the requirements of PU Code § 854(b) and (c) and directed the ALJ to process the application under PU Code § 854(a) in consultation with the Co-assigned Commissioners and to bring any decision before the entire Commission. The Commission affirms these findings in the CACR.

6. Applicants have stated in their application that they have a commitment to the residential local service markets.

7. MCIC will have the expertise and financial backing of the WCOM group.

8. The merger is economically and financially feasible. Both companies are fiscally healthy, and the merger with WCOM will increase MCIC's and WCOM's financing options at a time of increased competition. The price paid for the

shares is fair and reasonable considering the value to both WCOM and MCIC shareholders.

9. The merger will enhance each applicant's competitive ability. Efficiencies and operating cost savings will accrue. Access to more financing at a time when both applicants are trying to improve infrastructure and technology while operating in competitive global markets is likely to lead to better service conditions for MCIC's and WCOM's California ratepayers.

10. The combination of services the combined company will provide and the advanced technology it will be able to deploy will enhance service options for California ratepayers. Enhancing MCIC's competitive position with WCOM's expertise and financial standing will be likely to increase competition in the local telecommunications market, which furthers this Commission's policies to promote competition.

11. MCIC's affiliation with WCOM's internet, cellular and paging interests will enhance service on a global scale to California wireless customers. Global product development and marketing of global services will make California businesses better able to compete in international markets.

12. WCOM is experienced, financially responsible and more than adequately equipped to continue MCIC's business under the proposed combination.

13. The merger will improve the financial condition of the acquired MCIC and the quality of service to California ratepayers.

14. The merger will maintain the quality of management of the California-certificated MCIC subsidiaries.

15. The merger is fair and reasonable to affected utility employees due to the applicants' projected 20% revenue growth post merger which will foster new job opportunities.

16. To the extent that the utility assets are being transferred at a fair price, the merger is fair and reasonable to the majority of each applicant's shareholders due to the value-based price of the acquired corporation and the fact a majority of shareholders have approved the merger.

17. The merger will also be beneficial overall to state and local economies and communities in the area served by MCIC by virtue of the commitment to deployment of advanced technologies and increased service offerings MCIC's FAP and numerous low-cost interexchange rate plans, MCIC's efforts in the Hispanic market, and the uninterrupted presence of MCIC and WCOM offices in California communities.

18. Our jurisdiction is preserved and we will maintain our capacity to effectively regulate and audit MCIC's and WCOM's operations in California.

19. All PU Code § 854(c) criteria are met by the proposed merger.

20. The EC and the DOJ's Antitrust Division have approved the merger, subject to conditions which will protect the interests of California consumers against any anticompetitive behavior in the ISP and internet backbone markets as a result of the merger.

21. The AG has rendered his opinion finding no anti-competitive impacts from this merger in intrastate or interstate markets. We concur with the AG's findings.

22. Considering all relevant public interest factors, this merger, on balance, is in the public interest.

23. Competitive market forces will distribute the benefits of this merger to MCIC's California ratepayers.

24. It can be seen with certainty that the proposed transfer will not have an adverse impact on the environment.

Conclusions of Law

1. The application should be granted as it is in the public interest.

2. Given the applicants' commitment in their application as to local residential service and our Rule 1, it is not necessary to act on protestants' concerns in this area.

3. This authority is not a finding of the value of the rights and property to be transferred.

ORDER

IT IS THEREFORE ORDERED that:

1. On or after the effective date of this order, MCI Communications Corporation (MCIC) is authorized to merge with WorldCom, Inc. (WCOM) in accordance with the terms described in Application (A.) 97-12-010.

2. MCIC and WCOM and their California certificated subsidiaries shall continue to use their existing corporate identification numbers in the caption of all original pleadings and in the titles of pleadings filed in existing cases with the Commission.

3. MCIC shall file with the Commission's Docket Office for inclusion in the formal file of A.97-12-010 written notice that the authorized change in control has been completed, within 30 days after the change in control has taken place.

4. The authority granted in Ordering Paragraph 1 shall expire if not exercised within 12 months after the effective date of this order.

5. In the event that the books and records of the applicants or any affiliates thereof are required for inspection by the Commission or its staff, applicants shall either produce such records at the Commission's offices or reimburse the

Commission for the reasonable costs incurred in having Commission staff travel to either applicant's offices.

6. Application 97-12-010 is closed.

This order is effective today.

Dated August 31, 1998, at San Francisco, California.

RICHARD A. BILAS
President
P. GREGORY CONLON
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners

I will file a concurring opinion.
/s/ P. GREGORY CONLON
Commissioner

P. GREGORY CONLON, Commissioner, concurring

I concur on this decision with some reservations. Although I do believe that the MCI/Worldcom merger will produce a stronger player in the telecommunications market and a rival to Pacific Bell and GTE-California, I have concerns about the growing number of merger transactions purported to be pro-competitive, and the resulting increase of concentration within that market. It seems that the response of carriers to the Telecommunications Act of 1996 has not been to vigorously compete in each other's service territories, but to seek strategic alliances and ever larger size. As a result, four years after the California Legislature and Governor Wilson directed the Commission to open all California telecommunications markets to competition, and two and half years since the passage of the 1996 Act, we do not have significant local exchange competition for residential customers, with some limited exceptions, but we do have huge mergers in the works that threaten to replace a few monopolies across the country with an oligopoly of two or three giant companies.

As the Co-assigned Commissioner in this proceeding, I was inclined at one point to support monitoring of the merged entity to ensure that it followed through on its commitments to a competitive residential local exchange market. This merger involved MCI, a company that abandoned the residential local exchange market when it gave up its resale strategy, and Worldcom, whose various facilities-based competitive-local-carrier subsidiaries all have targeted the business market. Instead of requiring reports, though, I am willing to rely on MCI/Worldcom's representations to this Commission that it will pursue the residential local exchange market. I will do what I can to see this come true, and I will encourage this and future Commissions to do the same. Otherwise, we may find one day that the residential ratepayer has not received the promised benefits of competition, including choice of carriers and innovative services, called for in the 1996 Telecommunications Act, state law, and our own efforts, and instead will have a more expensive telephone bill designed to recover the giant carriers' costs of going global.

SAN FRANCISCO, CALIFORNIA
SEPTEMBER 3, 1998

/s/ P. Gregory Conlon
P. GREGORY CONLON
MEMBER OF THE COMMISSION