Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

In re Applications of	)	
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INTERMEDIA COMMUNICATIONS INC.,	)	
Transferor,	)	
	)	
and	)	
	)	
WORLDCOM, INC.,	)	CC Docket No. 00-206
Transferee,	)	
	)	
for Consent to Transfer Control	)	
of Corporations Holding Commission	)	
Licenses and Authorizations Pursuant	)	
to Sections 214 and 310(d) of the	)	
Communications Act and Parts 21,	)	
63, 90, 101	)	

REPLY TO PETITION TO DENY APPLICATION FOR CONSENT TO TRANSFER CONTROL

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Dated: December 19, 2000

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I. Introduction and Summary

The Application of WorldCom and Intermedia demonstrated that this transaction is in the public interest and will not harm competition for local, long distance, or Internet or Internet-related services.[1] In particular, the Application showed that combining the complementary strengths of Digex and WorldCom in the website and web-enabled applications hosting businesses will create a more effective and innovative competitor for those services.

On November 17, 2000, the United States Department of Justice announced that in order to address its antitrust concerns, WorldCom and Intermedia had agreed to a divestiture that would allow WorldCom to retain Intermedia's controlling stock interest in Digex Inc. while selling the remaining business operations and assets of Intermedia. The Department's Antitrust Division filed a lawsuit challenging the original transaction and at the same time filed a proposed consent decree in U.S. District Court. Applicants disagree with the Department's allegations regarding the competitive effects of the transaction, but the divestiture is consistent with WorldCom's business plans for the Intermedia assets, and the Applicants have agreed to it in order to resolve any potential issues and to expedite closing the transaction. The Department of Justice stated that the consent decree, if approved by the court, would resolve the lawsuit and the Department's concerns about the competitive effects of the transaction.[2]

AT&T Corp. ("AT&T") is the only party that opposes this transaction. AT&T, of course, currently competes with both WorldCom (in a number of businesses) and Digex (in web hosting), and will continue to face competition for those services after this transaction has closed. AT&T's allegations that WorldCom's acquisition of control of Digex will cause competitive harm are neither based in fact nor grounded in economic theory, and moreover are flatly contrary to the findings of the United States Department of Justice.

The Commission has never asserted jurisdiction over Internet businesses like web hosting, which AT&T now appears to suggest should be regulated. Further, the Commission should dismiss AT&T's speculative claims regarding the effect of the transaction on competition

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[1] Application for Consent to Transfer Control, submitted in Applications of Intermedia Communications, Inc. and WorldCom, Inc. for Consent To Transfer Control, CC Docket No. 00-206 (filed October 23, 2000) ("Application").

[2] Justice Department Requires WorldCom Inc. to Sell Intermedia in Order to Retain Controlling Interest in Digex Inc., November 17, 2000, http://www.usdoj.gov/opa/pr/2000/November/666at.htm ("DOJ Press Release"). The Proposed Final Judgment and the Hold Separate Stipulation and Order, which set forth the terms of the agreement between the Department of Justice and the Applicants, were provided to the

for Internet backbone services in light of the Department of Justice's statement that the proposed consent decree resolves the Department's concerns about the transaction. In sum, the Commission should give no credence to AT&T's transparent effort to delay needlessly approval of the transaction, and, consequently, should summarily reject AT&T's claims, and approve the transaction expeditiously.

II. The Transaction Will Not Harm the Thriving Competition Among Providers of Internet Services

A. Competition to Provide Internet Backbone Services is Flourishing

In their Application, WorldCom and Intermedia demonstrated that the supply of Internet services continues to grow at an incredible pace, and that the merger of Intermedia and WorldCom would not have any adverse effects on this trend.[3] The Application contained quantitative information from public sources documenting the extraordinary expansion in Internet bandwidth, ISPs, hosts, and Internet traffic. The Application also showed that entry into the provision of Internet services is easy, because of the ready availability of fiber capacity at competitive prices.

Recognizing that it could not rebut this showing of robust competition among Internet service providers, AT&T instead breezily claims that the "evidence accumulated" in the *WorldCom-MCI* and *WorldCom-Sprint*[4] proceedings demonstrated that "UUNET is already approaching a dominant position in this market" and "anticompetitive 'network effects' are a

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Commission for inclusion in this docket, under cover of a letter from Mary L. Brown and Heather B. Gold to Magalie Roman Salas, dated November 20, 2000.

[3] Application at 19-20.

[4] In the Matter of Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control, CC Docket No. 97-211, 13 FCC Rcd 19025 (1998); In the Matter of Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from Sprint Corporation to MCI WorldCom, Inc., CC Docket No. 99-333.

very real possibility if WorldCom is allowed to merge with another Internet Backbone Provider (IBP)."[5] AT&T's allegations are irrelevant as well as incorrect.

First, AT&T's assertions with respect to the competitive impact of a hypothetical WorldCom merger with another Internet service provider are completely irrelevant, since the Intermedia backbone assets will be divested, and not combined with the WorldCom backbone assets as a result of this transaction. Intermedia provides, *inter alia*, Internet backbone service, while Digex provides exclusively web hosting services. In the Application, WorldCom stated explicitly that, for business reasons, it intended to sell all, or substantially all, of the Intermedia assets (excluding its Digex shares).

Further, the Proposed Final Judgment submitted by WorldCom, Intermedia, and the Department of Justice would require WorldCom to divest those assets within 180 days after closing.[6] In the interim, the Hold Separate Stipulation and Order requires WorldCom, after this transaction closes, to operate Intermedia as an "independent, ongoing, economically viable and active competitor in the provision of telecommunications services."[7] Thus, under the terms of the agreement with the Department of Justice, Intermedia will continue to operate as a separate, stand-alone entity, until the sale is completed.[8] In short, WorldCom will not acquire any

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[5] Petition of AT&T Corp. to Deny Application to Transfer Control, CC Docket No. 00-206 (filed December 6, 2000) ("AT&T Petition") at 5. AT&T's petition suggests incorrectly that the Commission has previously concluded that Internet backbone services constitute a separate relevant product market. AT&T Petition at 4-5, citing the Commission's *WorldCom-MCI Order*. In fact, the Commission stated that it "need not decide which market is the relevant market for purposes of evaluating the competitive effects of the merger." *WorldCom-MCI Order*, 13 FCC Rcd 19025, at para. 148. In the view of WorldCom, the relevant product market is broader than simply Internet backbone services.

[6] Proposed Final Judgment at 4.

[7] Hold Separate Stipulation and Order at 7.

[8] AT&T frequently relies on allegations advanced in the course of litigation as if they were adjudicated facts. For example, AT&T discusses the divestiture of the MCI Internet backbone

additional Internet backbone assets as a result of the transaction. Rather, the Intermedia backbone assets will be owned and controlled by a third party. The identity of the third party will be approved by the Department of Justice.

Moreover, AT&T's unsubstantiated allegations with respect to WorldCom's "near dominance" are demonstrably wrong. In their Application, WorldCom and Intermedia showed that existing Internet Service Providers (ISPs) continue to expand their capacity to meet unprecedented growth in demand from residential and business customers as well as other ISPs. Entry into the supply of dedicated Internet access services can be achieved relatively quickly and at low costs, with the result that new entrants and once-smaller ISPs continue to establish themselves as competitive forces. Moreover, in order to provide the universal connectivity demanded by end users, ISPs are interconnecting with each other on an ever-increasing basis.

The publicly available information provided in the Application plainly shows that the number of ISPs is large and growing.[9] In addition, expert testimony and other evidence submitted by WorldCom and others in the *WorldCom-Sprint* and *WorldCom-MCI* proceedings, demonstrated that entry and expansion by ISPs over the past several years has continued unabated at phenomenal rates, and did not support a market dominance argument. For example, in the *WorldCom-Sprint* proceeding, the Applicants showed that the Internet business has expanded at a tremendous rate since 1998, that virtually all ISPs operating backbone networks had expanded those networks, and that many new ISPs had begun providing service.[10] Indeed,

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assets to Cable & Wireless (C&W) without reference to the fact that the transfer of these assets strengthened C&W's position as one of the world's leading Internet backbone services.

[9] Application at 19-20.

[10] Reply to Comments and Petitions to Deny Application for Consent to Transfer Control, filed by Sprint Corporation and MCI WorldCom, Inc., CC Docket No. 99-333, at 89. That expansion continues. For example, Morgan Stanley has recently revised its rating for Level(3)

one of the clear signs of the vigorous competition that characterizes the Internet marketplace is the fact that in the space of just a few years, AT&T has been able to enter the business and become one of the largest ISPs in the world.[11]

In contrast to this overwhelming evidence of the growth and expansion in all segments of the Internet business, AT&T purports to base its characterization of the industry on two estimates of WorldCom's share of the Internet backbone business: a Department of Justice traffic study that estimated WorldCom's share in February 2000 to be 37%, and an IDC report that estimated WorldCom's share of the wholesale segment in 1999 to be 43%.[12] It bears mention that AT&T previously has claimed that WorldCom's share of the wholesale segment was 34%.[13] In any event, neither estimate AT&T has submitted in this proceeding is reliable, and neither, even if reliable, would substantiate AT&T's claim that WorldCom is "near dominant."

WorldCom has shown in prior submissions to the Commission that there was no reliable basis for estimating shares of different backbone providers.[14] The differing methodologies for the share estimates provided by AT&T in this proceeding underline the fact that there continues to be no generally accepted standard for estimating the relative shares of Internet backbone providers. The IDC study cited by AT&T, for example, used revenues to estimate shares. The fundamental flaw in that approach is that not all firms offering Internet backbone services are publicly traded firms, and are not required to disclose their revenues or other financial information. As a result, it is impossible to calculate with any precision the total revenues

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Communications to "outperform," stating that Level 3 continues to be ahead of schedule on its network buildout.

[11] Application at 23.

[12] AT&T Petition at 6, n. 16.

[13] AT&T Petition to Deny, CC Docket No. 99-333 (February 18, 2000), at 8. AT&T did not specify the method it used in arriving at its estimates (*e.g.*, revenues, connections).

generated by Internet backbone services. Moreover, even firms that do disclose financial information do not report Internet-related revenues in a consistent fashion, which also precludes an accurate computation of shares.

The share estimates in the Department of Justice complaint are also of doubtful validity. As a threshold matter, it is important to keep in mind that those estimates are derived from traffic data obtained from WorldCom, Sprint, and selected third parties as part of the merger review process, and, of course, have no probative value. The Department's suit having been settled, these estimates do "not constitute any evidence against or admission by any party regarding any issue of fact or law."[15]

Further, there is strong reason to believe that the underlying assumptions, methodology, and conclusions of this untested traffic study are significantly flawed. For example, the traffic study undertaken by the Department purported to measure traffic flows among only a portion of ISPs, and those ISPs appear to have measured their traffic using different methodologies. Although the Department may have sought to reconcile inconsistencies in the data, it has never revealed: (1) the protocols or methods that any participant followed in collecting data or reporting it; (2) the raw or summary data collected and the stated qualifications or assumptions reported by participants; or (3) the methods used by the Department to reconcile inconsistent data.

Indeed, once certain computational errors in a traffic-share analysis conducted by the European Commission based on the same data were identified and corrected by WorldCom, the results showed that the combined share of WorldCom and Sprint would have been no more than

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[14] Reply to Comments and Petitions to Deny Application for Consent to Transfer Control, filed by Sprint Corporation and MCI WorldCom, Inc., CC Docket No. 99-333, at 95-96.
[15] Proposed Final Judgment at 1.

27-38%.[16] Finally, the static result of a traffic study conducted in February 2000, even if an accurate snapshot as of that date, would not be probative of the company's current and future position, given the dynamic nature of the market, as well as indications that WorldCom has lost share to other competitors.[17]

In any event, none of the erroneous share estimates cited by AT&T supports a finding that WorldCom is "approaching a dominant position." As described in the Application, competition among ISPs is flourishing, and ongoing changes in the Internet industry, such as continued ease of entry and expansion, ensure that competition will intensify in the future.

B. WorldCom's Acquisition of Digex Will Produce Significant Pro-Competitive Benefits for Consumers

As the Application demonstrated, approval of this transaction will result in significant benefits for consumers, and will in no way adversely affect the existing robust competition for Internet and Internet-related services, including web hosting and Internet backbone services. AT&T's claims with respect to the effects of this transaction on other providers of web hosting and Internet backbone services are groundless and completely inconsistent with the conclusions of the Department of Justice. We note that the Commission has never asserted jurisdiction over web hosting services, and has steadfastly declined to regulate the Internet.[18] AT&T's frivolous

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[16] The European Commission ("EC") study relied on the same input data as that used by the Department of Justice. However, the EC merger review process afforded the parties limited access to the European Commission's analysis (although not to the input data or methodologies used by the respondents). WorldCom has filed an application to annul the EC decision, including the referenced traffic study and the market share estimates derived from the study, with the European Court of First Instance in Luxembourg.

[17] The data on which the European regulators relied, for example, indicated that UUNET had lost share to competitors, including, no doubt, new entrants such as AT&T, Qwest and Level 3.

[18] *See, e.g.,* In the Matter of Local Competition and Broadband Reporting, Notice of Proposed Rulemaking, CC Docket No. 99-301 (released October 22, 1999) at para. 61 (stating that the "Commission does not regulate internet (sic) services . . . ."); In the Matter of Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities, Notice of

objections clearly do not justify a departure from this established precedent. The Commission should flatly reject AT&T's inexplicable request that the Commission use its limited resources to regulate the highly competitive web hosting business, based on AT&T's unfounded objection to a transaction that the Department of Justice has permitted to go forward, subject to a consent decree.

The Department of Justice concluded that its agreement with WorldCom and Intermedia, as reflected in the Hold Separate Stipulation and Order and the Proposed Final Judgment, addresses all of the competitive concerns raised by the transaction. Douglas Melamed, the acting Assistant Attorney General of the Department's Antitrust Division observed that, "The divestiture of Intermedia will preserve the competitive structure of the Internet backbone market, while permitting WorldCom to acquire the Digex web hosting business that does not pose a threat to competition."[19] Thus, AT&T's arguments flatly disagree with the Department's assessment, and should be given no weight by the Commission. As the Department of Justice has stated, the consent decree, if approved by the court, would resolve the Department's concerns.[20] The Commission therefore should conclude that the substantive claims with respect to the effect on competition raised by AT&T have been addressed by the actions of the Department of Justice.

AT&T's competitive effects arguments are also substantively wrong. Recognizing that the transaction involves no significant horizontal overlaps that might raise competitive concerns, AT&T advances two vertical theories. AT&T's first vertical argument is that the transaction will lessen competition in the web hosting business because of vertical effects flowing from

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Inquiry, GEN Docket No. 00-185 at para. 42 (describing the Commission's "historical policy of not regulating the Internet").

[19] DOJ Press Release at 1.

WorldCom's position in the provision of Internet backbone services.[21] As the declaration of Dr. Michael Pelcovits demonstrates, AT&T's argument is unsupported by fact or theory. [22]

AT&T's theory of competitive harm requires it to show that WorldCom, by acquiring control of Digex, will gain the incentive and the ability to disadvantage Digex's rivals in order to gain market power in the web hosting business. In fact, WorldCom has neither the incentive, nor the ability, to raise the costs of web hosting competitors.

First, the central erroneous assumption of AT&T's theory is that WorldCom possesses market power in the provision of Internet backbone services, an allegation that AT&T bases entirely on its speculative estimates of WorldCom's share of backbone services. Even if one were to accept, *arguendo*, AT&T's assertion that WorldCom carries 37% of domestic Internet backbone traffic, that share falls far short of what would be necessary to exercise market power.[23] In these circumstances, as Dr. Pelcovits demonstrates, there is plainly no plausible basis for the allegation that WorldCom has the ability to raise Digex's rivals' costs.[24] If WorldCom were to raise the price of its backbone services or degrade connection quality to rivals of Digex in an effort to raise their costs, WorldCom would simply lose customers of its backbone business rather than adding customers to Digex's web hosting business.

Second, the web hosting market is characterized by a large number of firms with small market shares, so that there is virtually no opportunity to restrain competition.[25] IDC estimates that Digex had a 3.3% share of U.S.-based web hosting service provider revenues at the end of

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[20] DOJ Press Release at 2.
[21] AT&T Petition at 8.
[22] Declaration of Dr. Michael D. Pelcovits (Pelcovits Declaration), attached as Attachment A.
[23] Pelcovits Declaration at para. 11.
[24] Pelcovits Declaration at paras. 10-13.
[25] Melanie A. Posey, Bulletin: Web Hosting Services: 1999 Market Share Assessment, IDC (2000) ("IDC Bulletin") at 3.

1999, and that WorldCom had a 4.4% share.[26] Although adding these shares would be misleading, as the products of the two companies are not close substitutes, the companies' combined share, in any case, would be less than 8%, which raises no plausible risk of restraining competition in web hosting.[27]

AT&T's second vertical theory, which posits anticompetitive effects in the Internet backbone market, is also meritless. AT&T contends that the shift of Digex's web hosting traffic to WorldCom will increase the volume of traffic carried by WorldCom's backbone, and that this "could very well tip the Internet backbone market."[28] Once again, AT&T is wrong on the facts as well as the theory. The facts are: (1) Digex does not have a significant volume of web hosting traffic transported over Internet backbone networks; and (2) a portion of that traffic is already carried by WorldCom. Therefore, even if all Digex traffic were shifted to WorldCom, the incremental gain in traffic would likely be insignificant.[29]

The more fundamental problem with AT&T's theory, however, is that it implies that the transaction would cause an anticompetitive increase in WorldCom's share of backbone traffic, when in fact, as Dr. Pelcovits explains, any increase in WorldCom's backbone traffic attributable to the merger would be a natural and competitively desirable consequence of its ability to offer customers a broader array of attractive services -- in this case, complex web hosting services -- due to its vertical relationship with Digex.[30]

[26] *Id.*
[27] Pelcovits Declaration at para. 6.
[28] AT&T Petition at 10.
[29] The rapid growth of Digex did not lead to dramatic traffic increases for Intermedia during the period Intermedia held Digex, which is further evidence for the proposition that acquiring a controlling stake in Digex is not a strategy for obtaining a greater share of backbone traffic.
[30] Pelcovits Declaration at paras. 24, 27.

AT&T's theories are simply inconsistent with standard competition policy analysis, as shown in the Pelcovits Declaration. Standard competition analysis assesses the vertical effects of a merger by determining whether a merged firm would be able to reduce quantity or raise prices in one of the two markets. Thus, AT&T would need to show that WorldCom would reduce quantity or raise prices for web hosting services, or would reduce quantity or raise prices for Internet backbone services. AT&T's analysis, however, assumes that the merged firm in this case would lower prices and raise output in both markets.[31] Lower prices and increased output are, in fact, the pro-competitive effects of this transaction.

Similarly, AT&T's "raising rivals' costs" analysis is completely at odds with standard vertical effects analysis. As described by Dr. Pelcovits, a "raising rivals' costs" vertical merger theory typically assumes that a firm with market power in one market seeks to use that power to acquire market power in a vertically related market, in effect extending market power from one market to another market.[32] Under AT&T's theory, both the web hosting business and the Internet backbone business are simultaneously the markets in which the combined company has market power, and the markets into which the combined company seeks to extend its existing market power.[33] There is a profound logical gap in AT&T's reasoning, which cannot be bridged by AT&T's obfuscatory rhetoric.

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[31] AT&T Petition at 8-10.
[32] Pelcovits Declaration at para. 26.
[33] *Id.*

III. AT&T's Remaining Challenges to the Transaction Are Without Merit

AT&T erroneously claims that there is no evidence in the record to support the view that this transaction will result in public interest benefits from either the affiliation of the web hosting businesses of WorldCom and Digex or the financial relief provided to Intermedia.[34] In fact, the Application contained expert testimony from WorldCom Vice President for Corporate Development, K. William Grothe, Jr., who described the specific benefits that the combination of WorldCom and Digex would produce.[35] Mr. Grothe explained that affiliation with Digex would accelerate WorldCom's time to market for complex managed Web hosting services by at least 12 to 18 months.[36] It is perhaps not surprising that AT&T would prefer that WorldCom be delayed as much as 18 months in its ability to compete for the business of customers seeking complex Web hosting services.[37] The objective of the Commission's merger review process, however, is not to shield AT&T from competition, but rather to ensure that the public interest is served by the transaction, as Applicants have demonstrated.

In addition, Mr. Grothe described how Intermedia, its shareholders, and its customers would also benefit from the transaction because Intermedia will be in a financially stronger position. As Mr. Grothe explained, the capital demands of operating Intermedia and Digex, on top of payments due on approximately $3 billion of debt, were lessening Intermedia's ability to support and expand Digex. In addition, WorldCom will provide support for a third-party credit facility to be granted to Intermedia, and has committed itself under the merger agreement to provide additional financing to Intermedia to fund operations through the closing of the

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[34] AT&T Petition at 3-4.
[35] Declaration of K. William Grothe, Jr., provided as Attachment A to the Application ("Grothe Declaration").
[36] Grothe Declaration at 1-2.

WorldCom merger.[38] The Hold Separate Stipulation and Order provides additional evidence that Intermedia will continue to be an effective competitor, as it requires Intermedia and WorldCom to "preserve, maintain, and continue to operate the Intermedia assets as an independent, ongoing, economically viable competitive business . . . ."[39] The record thus provides uncontroverted evidentiary support for the conclusion that this transaction will benefit customers of Intermedia, Digex, and WorldCom.

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[37] There are, of course, no barriers to entry or expansion in web hosting, and no restriction on AT&T's ability to expand its own web hosting business.

[38] Grothe Declaration at 2. Consistent with the Hold Separate Stipulation and Order, on October 31, 2000, WorldCom executed a guaranty pursuant to which WorldCom provided a guarantee for a $350 million credit facility made available to Intermedia by Bank of America and Bank of New York. In addition, Worldcom and Intermedia entered into a Note Purchase Agreement dated October 31, 2000, pursuant to which WorldCom provided a $225 million subordinated debt facility to Intermedia.

[39] Hold Separate Stipulation and Order at 5-6.

IV. Conclusion

The record plainly establishes that the public interest will be served by the proposed transaction. The Applicants respectfully urge the Commission promptly to grant the Application.

Respectfully submitted,

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Dated: December 19, 2000

CERTIFICATE OF SERVICE

I, Kanika Johnson, do hereby certify that on this 19th day of December, 2000, I caused a copy of the foregoing Reply to Petition to Deny Application For Consent to Transfer Control to be served upon each of the parties listed on the attached Service List.

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Kanika Johnson

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ATTACHMENT A

Before the
FEDERAL COMMUNICATIONS COMMISSION
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DECLARATION OF MICHAEL D. PELCOVITS

December 19, 2000

DECLARATION OF MICHAEL D. PELCOVITS

1. I am Michael Pelcovits, Ph.D., Vice President and Chief Economist at WorldCom. I have been employed for twelve years at WorldCom (and formerly at MCI). In my present position, I am responsible for supervising economic analysis of public policy issues before federal, state, and international government bodies. Prior to my employment at WorldCom/MCI, I worked as a consultant on telecommunications economics, and served as a Senior Economist in the Office of Plans and Policy at the Federal Communications Commission. I received my Ph.D. in Economics from the Massachusetts Institute of Technology in 1976. I have published several articles on telecommunications and international economics.

2. In this declaration, I analyze the competitive impact of WorldCom's acquisition of a controlling interest in Digex and examine the facts and logic related to AT&T's assertion that the transaction will harm competition.

3. The transaction does not involve any significant horizontal overlaps that might raise competitive concerns. AT&T suggests that the transaction will lessen competition in two areas, for Internet backbone services and for web hosting services, but it does not propose that there is any significant horizontal overlap between Digex and WorldCom in either of these two areas. Thus, AT&T's attack on the transaction starts out with two strikes against it.

4. While both WorldCom and Intermedia provide Internet backbone services, the transaction will not lead to a combination of WorldCom and Intermedia as the latter will be sold. The transaction does not affect the number of competitors or otherwise increase concentration in the provision of Internet backbone services.

5. Nor does the transaction involve a competitive overlap of any significance in the supposed "web hosting market," though both WorldCom and Digex do provide web hosting services. [40] There are two reasons for this. First, the shares of the two firms in the web hosting business are very small. Second, the two firms offer distinctly different types of web hosting services.

6. IDC estimates that Digex had a 3.3% share of U.S.-based web hosting service provider revenues at the end of 1999, and that WorldCom had a 4.4% share.[41] Although adding these shares would be misleading, as the products of the two companies are not close substitutes, the companies' combined share would be less than 8%, which raises no plausible risk of reducing output or raising prices for web hosting services. In addition, the same IDC report details "disruptive" entry by technologically capable and well-funded firms.[42]

7. The focus of WorldCom's web-hosting efforts, for approximately eighteen months, has been the provision of colocation services and related simple shared web hosting services. As a result of this focus, WorldCom does not have a strong presence in the managed web hosting business. Digex, in contrast, does not supply colocation services or shared web hosting services, instead offering complex managed web hosting services. These very different product positions show once again that there is no significant horizontal overlap as a result of this transaction.

[40] AT&T assumes, without any empirical demonstration, that web hosting services constitute a separate, relevant market, and that, likewise Internet backbone services constitute a separate, relevant market. I do not agree with AT&T's assumptions, and my use of the terms "market" or "market power" in this declaration should not be interpreted as agreement with AT&T's proposed market definitions.

[41] Melanie A. Posey, Bulletin: Web Hosting Services: 1999 Market Share Assessment, IDC (2000) ("IDC Bulletin") at 3.

[42] *Id*., p. 9. These entrants include Dell, Gateway, Micron, Intel, and integration powerhouses EDS and CSC.

8. In the absence of any significant horizontal overlaps, AT&T advances what appear to be two different vertical effects theories. The first theory posits that WorldCom will leverage its supposed market power over Internet backbone services into web hosting services. The second theory posits a vertical effect in the opposite direction, whereby the increased volume of web hosting business will allow WorldCom to increase its supposed market power in the Internet backbone business. Perhaps giving these theories greater cohesiveness than AT&T's discussion itself does, I will examine each in turn and demonstrate why they (or similar, more carefully stated, theories) cannot be reasonably applied to this transaction.

9. Under the first theory, AT&T asserts that WorldCom will harm competitors offering web hosting services by raising the price of its Internet backbone services to them and/or degrading the quality of their interconnection with WorldCom's backbone. AT&T argues that this is an application of the "raising rivals' costs" theory.

10. For this transaction to lead to harm to competition under such a theory, it must be true that WorldCom, as a result of the Digex acquisition, will be propelled into a situation where it has both the incentive and the ability to disadvantage Digex's rivals in web hosting. In fact, WorldCom does not have, and will not gain from the transaction, either the ability or the incentive to raise web hosting rivals' costs to gain market power.

11. I will first address whether WorldCom has the <u>ability</u> to raise rivals' costs. The prerequisite for a firm to leverage market power from one market into another is that it must have power in one market to begin with. WorldCom does not have market power in provision of Internet backbone services, so there is nothing for it to

leverage. Even if one were to accept AT&T's assertion that WorldCom handles 37% of "backbone traffic," that share falls far short of what would be necessary to exercise market power to harm rivals in the web hosting business. Competing providers of web hosting services have alternatives to the WorldCom backbone, and those other backbones can easily expand capacity to handle increased demand from web hosting companies.

12. Further, web hosts typically connect to multiple backbones (and indeed stress that fact in marketing their services) and consequently could easily shift traffic from WorldCom to another provider in the event of a price increase or service degradation. Therefore, there is no rigidity in the market of which WorldCom could take advantage to harm rivals in the web hosting business.

13. The situation falls far short of one in which WorldCom has the ability to raise Digex's rivals' costs, and also falls short of one in which, as AT&T suggests, "interconnection with UUNet's Internet backbone is critical."[43] WorldCom is not in a position to compel web hosting customers that would prefer a rival's services to switch to Digex. If WorldCom were to raise the price of backbone services or degrade connection quality to those rivals, it would lose backbone business rather than gaining web hosting business. The market mechanism would lead to substitution away from those increases in prices (or degradations in quality) in a direct and efficient manner – using less of the WorldCom backbone – rather than an indirect and inefficient one – switching web hosting business to Digex.

14. The next part of my analysis considers whether, even if WorldCom had the ability to raise the costs of its web hosting rivals, it would have the incentive to do so. Clearly,

the benefit from raising rivals' costs would come from accumulating power in the downstream market. So it is important to examine whether WorldCom (plus Digex) could gain a strong monopoly position in the web hosting business. I do not believe this is possible.

15. Digex's share of the web hosting business, as I explained above, is approximately three per cent. Even if that share were combined with WorldCom's share of less than five per cent (which, as noted earlier, would be adding apples and oranges given that the two companies' products are not close substitutes), the resulting share of less than eight per cent is not a sufficient basis from which to begin to attempt to monopolize web hosting.

16. Suppliers in the web hosting business include AT&T, market leaders Exodus and Verio, as well as such successful firms as IBM, Qwest, and GTE, among many others, plus new entrants.[44] This is not a situation in which a few remaining competitive suppliers of web hosting services can be targeted for price increases or service degradations, leaving Digex and WorldCom's existing web hosting business as the only significant suppliers. Nor is it a situation in which eliminating even a great deal of competition would leave only a few competitors in a highly concentrated market.

17. The transaction, in fact, has pro-competitive effects on the market that will provide economic benefits to customers. Astonishingly, AT&T alleges that this transaction should be rejected because it will enable Digex to reduce its "Internet connectivity

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[43] AT&T Petition at 2 (emphasis added).
[44] See IDC report, op. cit.

costs."[45] I agree with AT&T that lowering costs will be an effect of this transaction. The coordination of the two companies' complementary assets will enable provision of valuable services to customers at lower costs. This is, not, however, a reduction in competition, but rather a mechanism by which the transaction permits an expansion in supply, which directly benefits consumers.

18. AT&T also advances (although with even less analysis or logic) a second vertical theory that has the flow of causation going in the other direction. After the transaction, in this theory, WorldCom will take advantage of Digex's existing position in web hosting to create a new monopoly in the "Internet backbone market." This theory has no empirical or theoretical justification.

19. The specifics of AT&T's theory as stated are far from the facts of the marketplace. AT&T posits that the shift of Digex's "sizeable" web hosting traffic to WorldCom "will increase the volume of traffic carried by WorldCom's backbone, possibly tipping that market."[46] The basis for AT&T's assertion appears to be that it believes that there are a large number of "eyeballs" that will come to be controlled by WorldCom.

20. In fact, Digex's web hosting traffic is not very sizeable. AT&T's theory is based on an "eyeballs" view of the sources of web traffic. In fact, Digex serves large enterprises with low bandwidth needs, focusing on transactions, rather than content sites that attract "eyeballs." Digex does not provide the high bandwidth hosting services typically used for streaming video and high graphics content entertainment, but instead focuses on complex computing problems, such as transactions and

[45] AT&T Petition at 9.
[46] AT&T Petition at 10.

running complex databases. Transactions-based services such as Digex's typically use only a very small fraction of bandwidth. Therefore, even if all Digex traffic were shifted to WorldCom, the incremental gain in traffic would likely be insignificant, contrary to AT&T's tipping theory.

21. Further evidence for the proposition that a controlling stake in Digex is not the key to rapid increases in backbone market share is Intermedia's experience in the period it held Digex. The recent success and rapid growth of Digex did not translate into dramatic traffic increases for Intermedia's Internet backbone business.

22. AT&T's assumes, without providing any analysis, that the "Internet backbone market" is in danger of "tipping" to a monopoly. This assumption is inconsistent with sound economic analysis of the provision of Internet backbone services. A variety of technological and business arrangements argue against this highly competitive market becoming a monopoly. Providers of web content and services can and do connect directly to more than one firm's Internet backbone services. These providers can substitute away from Internet backbone services, in response to price increases, by means of strategies such as caching. Most importantly, even on the inflated figures relied upon by AT&T, the majority of Internet backbone services are still provided by firms other than WorldCom.

23. In short, for AT&T's second vertical theory to be plausible, several factual conditions must be met, but in fact, none is.

24. A more fundamental problem with this second theory is that AT&T is confusing competition on the merits by WorldCom with anticompetitive acts. AT&T complains that the CEO of WorldCom has said the transaction will lead to "very attractive

pricing" for network connectivity and capacity.[47] That may not be welcome news for competitors like AT&T, but it is certainly good news for customers who buy Internet backbone services. Far from being an attempt to monopolize an "Internet backbone market," this transaction is WorldCom's attempt to offer better and cheaper services to its customers.

25. AT&T's theories are inconsistent with standard economic competition policy analysis Vertical merger effects are assessed by determining whether the firm would be able to reduce quantity or raise prices in one of the two markets. AT&T's petition, however, posits that the transaction will lower price and raise output in both markets. These are pro-competitive effects of a transaction.

26. Similarly, AT&T's two separate vertical theories, taken together, are completely at odds with standard competition policy analysis. A vertical effects analysis typically has a firm extending its existing market power <u>from</u> one market <u>to</u> another, complementary market. AT&T, in its first theory, claims that WorldCom will be able to use its existing market power in the provision of Internet backbone services to force its backbone customers to use Digex's web hosting services in order to acquire control of the web hosting business. AT&T, in its second theory, asserts that WorldCom will be able to use Digex's existing market power in the provision of web hosting services to force Digex's customers to use WorldCom's backbone services in order to acquire control of the Internet backbone business. In other words, AT&T's theory makes both businesses the "from" markets as well as the "to" markets. This confusing logic is clear proof of the artificiality of AT&T's theories, and their inability to withstand sound empirical or theoretical analysis.

[47] AT&T Petition at 9.

27. In conclusion, WorldCom's acquisition of a controlling interest in Digex is typical of many efficient vertical arrangements in the marketplace that reduce costs and provide economic benefits to customers. AT&T seems to be concerned that WorldCom will be able to provide a mix of quality and price that is superior to what they can offer their own customers. If that happens, the transaction will turn out to be a good idea, both for WorldCom's shareholders and for customers of web hosting businesses. AT&T's allegation that the transaction will harm competition (not just competitors) is based on two separate (and inconsistent) vertical effects theories that fall apart like a house of cards once they must contend with facts about the marketplace.

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

/s/ Michael D. Pelcovits
Michael D. Pelcovits

Executed on December 19, 2000