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September 16, 2002

BY ELECTRONIC FILING

Marlene H. Dortch, Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Washington, D.C. 20554

Re: UNE Triennial Review – CC Docket No. 01-338
Local Competition – CC Docket No. 96-98
Deployment of Advanced Wireline Services – CC Docket No. 98-147

Dear Ms. Dortch:

Attached for inclusion in the record of the three above-referenced proceedings is a copy of a letter to Chairman Michael Powell from Donna Sorgi, Vice President of Federal Advocacy for WorldCom, together with attachments referenced therein.

Sincerely,

/s/Ruth Milkman
Ruth Milkman

Attachment

WORLDCOM

Donna Sorgi
Vice President
Federal Advocacy

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September 16, 2002

The Honorable Michael K. Powell
Chairman
Federal Communications Commission
Washington D.C. 20054

Re: Effect of UNE-P Pricing on BOC Profitability
UNE Triennial Review, CC Docket No. 01-338

Dear Chairman Powell:

Over the past few months, some Bell Operating Companies (BOCs) and some financial analysts have alleged that the success of competitive local exchange carriers (LECs) in attracting customers from the BOCs through use of the so-called unbundled network element platform (UNE-P) is putting pressure on the BOCs' profitability. These analysts' reports have been collected and filed in this docket by BellSouth and SBC.[1] This written *ex parte* responds to BellSouth's August 28, 2002 submission. We first place in perspective the concerns expressed by the BOCs, and show that, at bottom, they are rooted in a belief that the preservation of local exchange monopolies is a more desirable policy than competition, a policy choice that the Telecommunications Act of 1996 squarely rejected. We also attach: (1) a point-by-point rebuttal of BellSouth's description of "the problem with UNE-P;" (2) a discussion of certain flaws in the UBS Warburg analysis; (3) a discussion of certain flaws in the Commerce Capital Markets analysis; and (4) a Legg Mason analyst report that corroborates WorldCom's view of the effect of UNE-P.

As an initial matter, it bears emphasis that the consumers that primarily benefit from the availability of UNE-P offerings by competitive LECs are residential and small business customers. It is widely recognized that these customer segments are the ones that, until recently, have not enjoyed the fruits of local service competition that Congress contemplated when it passed the Telecommunications Act of 1996. Less than six months ago, for example, WorldCom introduced The Neighborhood built by MCI℠, a combined local and long distance service offering that uses UNE-P for access to BOC networks. This offering has been extraordinarily popular with residential customers – nearly a million have selected The Neighborhood in the past few months.

The BOCs, nonetheless, insist that the Commission should amend its existing rules to make UNE-P a less attractive alternative to their own local service offerings or those

[1] Letter from Robert T. Blau, BellSouth, to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 01-338 (Aug. 28, 2002); Letter from Brian J. Benison, SBC Telecommunications, Inc., to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 01-338 (Sept. 10, 2002).

provided on entirely separate networks. It is axiomatic that as the BOCs lose local customers to competitive LECs, the BOCs receive less local revenue than if they had retained the customers. The actual effect of local customer loss on a BOC's profitability, however, depends on a number of factors: the profitability of serving the customer, the savings that accrue to the BOC by not serving the customer, whether the BOC receives any revenue for providing facilities or services to the competitive carrier now serving the customer, and, finally, whether the BOC takes advantage of the opportunity to offset the local revenue loss by gaining long distance customers and revenues. It is counter-intuitive, therefore, that the BOCs would prefer to lose a customer to a competitor with end-to-end facilities, as opposed to a competitor that uses UNE-P. In the case of the UNE-P-based competitor, the BOC at least would still receive the UNE-P revenues.

Consequently, a statement by a BOC that UNE-P based competition is harmful, in fact, suggests that the BOC would prefer to have no competition at all. At a minimum, it indicates that the BOCs would prefer to face fewer competitors than they do under the FCC's current policies. Although financial analysts may share this view because it would reduce the risk of investing in incumbent monopolists, that policy is not the one mandated by Congress, and it is a policy likely to decrease, rather than increase, the amount of investment dollars in the telecommunications industry generally (though it might increase the flow of investment to the BOCs).

The BOCs publicly supported the Telecommunications Act of 1996 at the time of its passage.[2] Since the Act offered the BOCs the opportunity to enter their in-region interLATA long distance markets, their support of the new statute suggests they concluded that the increase in long distance revenues would offset losses in local revenues as local competition was introduced. And, in fact, the BOCs' calculation was correct. Experience demonstrates that once a BOC has interLATA authority in a given state, it gains long distance customers more quickly than it loses local customers. In New York, for example, Verizon increased its profitability after it received permission to offer long distance service in that state.[3]

It may well be true that BOCs are losing revenues in states where BOCs have not opened fully their markets to competition and received permission to offer long distance service. Fortunately for the BOCs, they control the timing of the receipt of authority to offer in-region interLATA services. Verizon decided that it would take the steps necessary to gain

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[2] *See, e.g.,* "BellSouth Reaction to President Clinton's Signing of the Telecommunications Act of 1996" (Feb. 8, 1996), *available at:* <http://bellsouthcorp.com/proactive/newsroom/release.vtml?id=10214>; "Ameritech Applauds Passage of Sweeping Telecom Legislation" (Feb. 1, 1996), *available at:* <http://www.ameritech.com/About/NewsCenter/ShowRelease/1,,183,00.html?id=2013>.

[3] *See* Attachment C, "Flaws in Commerce Capital Markets Analysis."

Section 271 authority, and now has approval in eight states, for 74% of its lines. Consequently, according to one financial analyst, Verizon's revenue stream is not endangered by UNE-P.[4] SBC and BellSouth, however, have delayed taking the steps necessary to gain Section 271 authority, and therefore have created a gap between the time at which UNE-P is available to their competitors, and the time at which SBC and BellSouth can offer long distance to the majority of their customers. Thus, to the extent that there is an issue with respect to pressure on profitability due to UNE-P competition, it is a temporary issue, one that does not affect all BOCs, and one that the affected BOCs have the power to cure. For example, Ed Whitacre, the CEO of SBC, has been aggressive about maintaining the profitability of his company,[5] but SBC has failed to apply for authority to offer in-region interLATA services in more than half of the states in its region. One might conclude from this combination of actions that SBC prefers to protect its local monopoly rather than to compete aggressively in the provision of long distance services.

We believe, moreover, that errors in the analysts' reports cited by BellSouth raise questions as to the validity of the claims regarding the pressure on the BOCs' profitability. For example, UBS Warburg understates: (1) the expected cost savings of serving a UNE-P customer rather than a retail customer; (2) demand for UNEs; and (3) the BOC margin for provision of long distance service.[6] Once one adjusts the analysis to correct for the understatement, it is clear that the BOCs need gain just over one long distance customer for each customer lost to a UNE-P-based competitor in order to maintain current levels of profitability.[7] In addition, in order to test the validity of the Commerce Capital Markets report, we analyzed the change in Verizon's net revenue in the New York residential market resulting from its entry into long distance, and CLECs' entry into local services.[8] This analysis shows that Verizon has gained over $5 million in monthly profits from the combined effect of Verizon's entry into long distance and UNE-P-based competition in the New York residential market.[9]

BellSouth has raised the question of whether, given current UNE-P prices, the revenue opportunity for the BOCs in long distance is a fair trade for the local revenues put at

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[4] Legg Mason, Equity Research Company Update, Verizon Communications, Inc., August 21, 2002 (Attached as Attachment D).

[5] *See, e.g.,* "SBC to Cut 5,000 Jobs in Second Quarter," San Antonio Business Journal (May 14, 2002), *available at:* <http://sanantonio.bizjournals.com/sanantonio/stories/2002/05/13/daily12.html>.

[6] See Attachment B, "Flaws in UBS Warburg Analysis."

[7] *Id.* The UBS Warburg report concluded that a BOC would be required to gain 5.4 long distance customers for each local customer lost to a UNE-P-based competitor.

[8] *See* Attachment C, "Flaws in the Commerce Capital Markets Analysis."

[9] *Id.*

risk by the introduction of competition. BellSouth's question is an odd one, given that the Communications Act requires that the BOCs open their networks to local competition in exchange for the opportunity to compete in long distance, and that TELRIC-based pricing has been upheld by the Supreme Court. Nevertheless, if one conducts an analysis grounded in fact, it is clear that the loss of customers (and revenues) to UNE-P-based competitors is more than offset by the gain of long distance customers (and revenues). Any "pressure on profitability" is a consequence not of the Commission's policies, but of particular companies' strategies with respect to the timing of taking the steps necessary to gain Section 271 authority.

Consequently, the Commission should reject BellSouth's arguments with respect to the effect of UNE-P prices on BOC profitability, and should ensure that UNE-P remains available as an entry strategy for competitive carriers that wish to serve residential and small business customers. UNE-P is the only entry vehicle that has proven successful in delivering local competition to residential and small business customers, and it is essential that the Commission's policies support the continued availability and development of UNE-P-based competition for these customers.

Sincerely,

Donna Sorgi/RM

Donna Sorgi

Attachments

cc: Commissioner Kevin J. Martin
Commissioner Kathleen Q. Abernathy
Commissioner Michael J. Copps
Marlene H. Dortch
Christopher Libertelli
Daniel Gonzalez
Jordan Goldstein
Matthew Brill
William E. Maher, Jr.
Jeffrey Carlisle
Tamara Preiss
Michelle Carey
Thomas Navin
Robert Tanner
Jeremy Miller

ATTACHMENT A

Reality Check: Response to BellSouth's August 28, 2002 Ex Parte on UNE-P

MYTH #1: *ILECs are losing retail lines and revenues to wireless, cable TV, and UNE-P, but the cost of maintaining ubiquitous local networks remains roughly the same.*

REALITY: Certainly, wireless carriers, cable TV companies, and CLECs using UNE-P are selling lines to retail customers. It is also plausible, but by no means certain, that at least some of those customers would have been served by the ILEC if these competitors were not in business, and thus represent a "loss" by the ILEC. However, there are several other reasons why ILEC line counts might be falling (*e.g.*, the general economic downturn, substitution of digital subscriber line service for second phone lines) and it is hard to see how a wireless customer of the ILEC counts as a loss of revenue. Nevertheless, cable TV companies and CLECs using UNE-P do serve some customers – 1.2 percent and 3.1 percent of all lines, respectively, according to the most recent data from the Commission.[1] Clearly, the ILECs are not yet losing massive numbers of customers to their competitors.

Nor is it the case that the ILEC's cost of providing UNE-P to a competitor and retail service to an end-user is roughly the same. BellSouth's claim that the cost of providing UNE-P and retail service is the same is based on the stock analysts' reports that BellSouth attaches to its ex parte notice of August 28, 2002. However, as explained in Attachments B and C, those analysts understate the expected savings from providing UNE-P. For example, UBS Warburg assumes without support that the BOC will be able to save about 6 to 8 percent of total costs.[2] However, the cost savings from total service resale average about 19 percent nationwide. Since these cost savings are based on the avoided retail costs, the cost savings from UNE-P should be very similar to this level. Correcting the analysis to reflect this greater cost saving greatly improves the profitability of UNE platform for the BOCs.

MYTH #2: *Some state commissions have abandoned any semblance of cost (including TELRIC) in setting wholesale rates, and instead are increasing resale discounts to levels that AT&T and other CLECs claim they need to operate profitably in residential markets.*

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[1] *See* Local Telephone Competition: Status as of December 31, 2001, Industry Analysis and Technology Division, Wireline Competition Bureau (July 2002), Tables 4 and 5, *available at:* <http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom0702.pdf>. These data report line counts as of December 31, 2001.
[2] *See* "How Much Pain From UNE-P?," Global Equity Research, UBS Warburg (Aug. 20, 2002) ("UBS Warburg Report"), attached to Letter from Robert T. Blau, BellSouth, to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 01-338 (Aug. 28, 2002) ("BellSouth ex parte").

REALITY: BellSouth's statement is not only untrue but an insult to the time and effort that the state public utility commissions and all participating parties have expended in the state cost proceedings. Those cost proceedings examine at great depth both the cost models and evidence presented by parties regarding the inputs to the cost models. Simply because BellSouth did not prevail with regard to its cost model and all associated inputs is no indication that the state commissions ignored cost in setting UNE-P rates. WorldCom cannot speak for AT&T or the other competitive LECs, but we can say that we do not believe that all state commissions have set rates at levels that guarantee our ability to operate profitably in residential markets.

MYTH #3: *Lower UNE-P rates are discouraging CLECs from incurring the cost and risk of overbuilding ILEC facilities. UNEs (UNE-P, 61% vs. UNE-L, 39%) now account for 47% of all (20 million) CLEC access lines up from only 24% at YE 1999.*

REALITY: CLECs are continuing to build their own networks. The same data cited by BellSouth shows that CLEC lines served on the CLECs' own facilities rose from 2.7 million lines at year-end 1999 to 6.1 million lines at year-end 2001. Setting UNE-P rates at economic cost (*i.e.*, TELRIC) gives CLECs the ability to enter markets and acquire customers, which in turn enables competitors to construct their own networks when it makes economic sense to do so. Similarly, when the BOCs start providing long distance, they begin by reselling capacity on interexchange carriers' networks, and presumably will eventually start building their own long distance networks when it makes economic sense to do so.

MYTH #4: *As CLECs become more dependent on reselling ILEC network capacity, price competition will continue to intensify in part because service differentiation between ILECs and CLEC resellers is not a viable option.*

REALITY: It is not true that CLECs will be able to compete only on price when they lease UNE-P. CLECs can compete by creating differentiated services, as WorldCom has done with its Neighborhood product, or in other ways not yet contemplated by the ILECs.

MYTH #5: *As price competition intensifies, further squeezing profit margins of all carriers, returns on capital will continue to deteriorate prompting facilities-based carriers to cut back capital spending that much more.*

REALITY: TELRIC pricing of UNEs reflects the economic cost of providing service, including an adequate return on capital to maintain a forward-looking network. If the ILEC's costs are above TELRIC, then the ILEC is inefficient, and will have to reduce its costs, as all competitive companies must. However, it is not true that the ILEC will have to reduce its capital spending.

MYTH #6: *At some point, reductions in capital expenditure by the ILECs will cause service quality to deteriorate much as it did in the Ameritech and US West states during the mid-to-late 1990s.*

REALITY: Prices set at TELRIC reflect economic cost, and thus will not require the ILEC to cut back on its capital expenditure. The service quality declines for Ameritech and US West were not the result of any forced reduction in capital expenditure, but resulted from business decisions made by those companies to direct their resources elsewhere.

MYTH #7: *If things get to the point that capital expenditures are limited, everyone—ILECs, CLECs, and consumers—will lose, and the damage done to the nation's communications infrastructure could be very difficult and costly to repair.*

REALITY: As already discussed, nothing about TELRIC pricing requires the ILECs to reduce their capital expenditures. Conversely, if the ILECs were allowed to charge a rate above TELRIC, nothing would require them to invest their resulting excess profits in maintaining the network. By holding UNE-P prices at TELRIC, the Commission will ensure that the ILECs will not be provided with a source of excess funds to spend on alternative ventures and that the ILECs will be more likely to limit their investments to maintaining the network.

MYTH #8: *The seriousness of these problems notwithstanding, the regulatory picture remains completely muddled.*

REALITY: This is the only point on which BellSouth is partly correct. The regulatory picture is muddled, but only because the Commission is considering drawing back from its previous determination that the ILECs must make UNE-P available at TELRIC rates. The Commission should remove this uncertainty by reaffirming that the ILECs must provide UNE-P at TELRIC rates. This will give all industry members the certainty they need to begin to make long-range investment decisions.

ATTACHMENT B

Flaws in UBS Warburg Analysis

BellSouth draws its erroneous points on the effect of UNE-P from several analysts' reports that it submits with its ex parte. These reports are based on several assumptions that misstate the effect of UNE-P and long distance entry on BOC earnings. In fact the BOCs are likely to increase their profitability when they provide the UNE platform and gain the right to provide long distance service. The analysts' incorrect conclusion that UNE-P will harm the BOCs' profitability is based on several errors.

a. Expected Savings are Understated

The analysts underestimate the cost saving from serving a UNE-P customer rather than a retail customer. For example, UBS Warburg assumes that the BOC will be able to save about 6 to 8 percent of total costs.[3] However, the retailing cost savings from total service resale average about 19 percent of the ILEC's embedded costs nationwide. Correcting the analysis to reflect this cost saving greatly improves the profitability of UNE platform for the BOCs.[4]

b. UNE Demand is Understated

The amount of UNE demand assumed can have a significant effect on the total UNE revenue received by the BOC. Since switching charges are a combination of per line and per minute charges, an increase in the number of minutes sold will result in greater UNE revenue.

The UBS Warburg analysis includes only 1,000 minutes of switching usage per month. This is well short of the minutes used by the Commission in its analysis of some

[3] *See* UBS Warburg Report. Warburg assumes savings of 5 percent of the cost of goods sold, which it estimates is about 30 percent of total sales, and 20 percent of sales, general and administrative expense, which it estimates is about 25 percent of total sales. Taken together, these two savings will yield between 5.95 and 6.75 percent savings on total sales, depending on the BOC.

[4] Using the residential avoided cost discount included in the UBS Warburg report instead of the assumed cost savings results in only 6 states having negative EBITDA from the provision of UNE platform, rather than the 18 states that UBS Warburg identifies. It also results in the BOC needing to capture only 4.5 long distance customers to make up for the lost EBITDA from each customer lost to UNE-P, versus the 5.4 long distance customers computed by UBS Warburg.

of the BOCs' 271 applications. Using the 2,400 local minutes assumed by the Commission greatly improves the profitability of providing UNEs.[5]

c. Long Distance Margin is Understated

Without providing any support, the analysts assume a very low margin for the provision of long distance by the BOCs. For example, UBS Warburg assumes only a 20 percent margin. However, WorldCom estimates that the BOCs' true margin is 59 percent.[6] This increase in BOC margin implies that the BOC will need fewer long distance customers to make up for the margin lost when local customers migrate to a competitor that uses UNE-P.[7]

Correcting only these three errors drastically changes the results of the analysis. UBS Warburg had estimated that the the BOCs would need to capture more than 5 long distance customers to make up for the profits lost from each local customer. With these three modifications, the BOCs would need to capture slightly more than one long distance customer. In the states in which the BOCs have met the requirements of section 271 of the Telecommunications Act of 1996 and been allowed to provide long distance service, they have captured much greater market share in long distance than they have lost in local. Therefore, the expected net effect from providing UNE-P and entering long distance is to improve BOC profitability.

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[5] Using this assumption in the UBS Warburg analysis results in only nine states having negative EBITDA from UNE-P, and the BOC needs to capture only 5 long distance customers to make up for each customer lost to UNE-P. Combined with the corrected cost savings, the BOC need only capture 3.5 long distance customers to make up for each customer lost to UNE-P.

[6] This is based on a retail rate of 10 cents a minute, access of 1.8 cents a minute, wholesale costs of 2 cents a minute, and uncollectibles of 0.3 cents a minute. The BOCs' uncollectible rate is based on 2001 data for the BOCs' state operations as reported in ARMIS 43-01.

[7] This higher long distance margin by itself means that a BOC needs only 2 long distance customers to make up for the lost EBITDA from each UNE-P customer. Combined with the two cost adjustments above, the BOCs would need just over one long distance customer to make up for each customer lost to UNE-P.

ATTACHMENT C

Flaws in Commerce Capital Markets Analysis

A report by Commerce Capital Markets ("CCM"), "The Status of 271 and UNE-Platform in the Regional Bells' Territories" dated August 22, 2002 (attached to BellSouth ex parte), posits that low UNE-P prices may undermine RBOC revenues and earnings and possibly lead to a sharp decline in RBOC stock prices. This report has received significant attention in the regulatory community because of the continued attacks on TELRIC pricing by the incumbent local exchange carriers. We believe the lessons drawn from the CCM report, however, are incorrect because it presents an incomplete and inaccurate picture of changes created in the market by the Telecommunications Act of 1996.

We now turn to the thesis of the report and explain the major flaws in the analysis, thereby showing that the RBOCs are not at great financial risk from the UNE-based competition fostered by the Telecommunications Act. The logic of the report is quite simple: the RBOCs lose money when they lose local customers to another provider. The report estimates the loss in revenue by comparing retail revenues per customer to wholesale revenues obtained from leasing UNEs.[8] The report then claims that the RBOCs will not save any costs when they lose a retail customer to a UNE-P provider, so the loss in revenue will translate dollar-for-dollar into lost profits.

The implication drawn by the RBOCs from this analysis is that UNE rates must be raised to protect them from a loss in revenues. We could not disagree more, either with the analytical foundation of the argument or the policy prescription. From an analytical standpoint the argument suffers from a one-sided look at the market and its failure to look at RBOC revenue opportunities in the long distance market. From a policy standpoint the RBOCs' argument reflects a failure to accept that competition can cut into the revenues of an incumbent. This is a simple fact about competitive markets that WorldCom and other long distance carriers have learned the hard way.

The "bargain" of the Telecommunications Act was that long distance carriers would be able to enter the local market, while the local carriers would enter the long distance market. In both markets, the incumbent carriers' revenues were to be put at risk. Sales of wholesale products to the new entrants would offset some of the revenue loss, but not all. Indeed, long distance carriers have more at risk when they lose retail

[8] Although the report represents that UNE rates are below embedded cost, this claim is secondary to the claim made about the risk to the RBOCs' financial strength. The threat to the RBOCs' profits from UNE-P, according to CCM, is entirely a function of the relationship of retail to wholesale rates and the short-term costs avoided when a retail customer is lost.

customers than the local carriers, because the wholesale discounts are greater in the long distance market than in the local market!

Notwithstanding that the "bargain" is law, the RBOCs seem intent on forcing an analysis of whether the revenue opportunity for the RBOCs in the long distance market is a "fair" tradeoff for the revenues put at risk in the local market. Fortunately, we do not have to speculate about the answer. New York provides a good laboratory of the combined effect on Verizon of local competition and long distance entry. (Considering that Verizon is the RBOC most "at risk" from UNE-P, according to the CCM report, our analysis shows a worst case outcome for any of the RBOCs.)

We have conducted an analysis of the change in Verizon's net revenue in the New York residential market resulting from their entry into the long distance market and the CLECs' entry into the local market. Our estimates are based on the most recent UNE rates and local retail rates, as well as information from public sources on market shares.[9] The analysis shows that Verizon has gained over five million dollars in monthly profits from the combined effect of their entry into long distance and UNEP-based competition in the New York residential market. Results of the analysis follow, and the backup is provided on a separate page.

[9] There is no analog to these numbers in Verizon's financial reports, because they do not report this type of information on a disaggregated basis.

Change in Verizon's monthly profits from new entry into local and long distance residential markets in New York

Step 1: Loss of net revenue from loss of a retail customer to a UNEP-based CLEC

Retail revenue per line		$38.91
(-) UNE-P revenue per line		19.87
Loss in revenue per line	=	19.04
(-)Avoided cost		6.85
Change in net revenue	=	$12.19

Step 2: Gain in net revenue from new long distance customer

Long distance revenue per line	$14.00
(-) Access charges	2.52
(-) Wholesale cost of service	2.80
Net Revenue	$ 8.68

Step 3: Estimates of Verizon's N. Y. customer base

Total Residential Lines	7,655,000
Loss of local share	23%
Gain of long distance share	40%
Estimate of lost local lines	1,760,650
Estimate of gained long distance lines	3,062,000

Step 4: Compute Change in Net Revenue

Lost local lines	1,760,650
Decline in net revenue per line	$12.19
Estimated decline in net revenue from local	**$21,462,000**

Gained long distance lines	3,062,000
Increase in net revenue per line	$8.68
Estimated increase in net revenue from LD	**$26,578,000**
Change in net revenue, combined effect	**$5,116,000**

Conclusions

- Contrary to the conclusions of the CCM report, we do not find the RBOCs to be at risk of substantial revenue losses from UNE-P-based competition. Instead, the tradeoff of increased long distance revenues *more than offsets* the loss from local competition.

- Our analysis of the New York market presents a worst case, because the spread between retail local rates and UNE-P rates is among the highest in the nation, thus exposing the RBOC to the greatest potential loss of local revenue.

- Even if Verizon avoided only 10% of their retail cost, their net revenues would be unchanged.

- The RBOCs' prescription to raise UNE rates in order to stimulate more facilities-based local competition could actually erode more of their revenues, because they would receive no UNE revenues from facilities-based competitors. The RBOCs must believe that facilities-based residential local competition is not possible, or they would be much more willing to resell their own facilities to competitors.

VZ - NEW YORK
Per Customer/ Per Month

Local Retail[1]		Local Wholesale[2]		RBOC with LD	
Line Fee	$24.56	Loop	$12.34	Local Retail	
Feature (Call Waiting)	$5.19	Port	$2.57	Line Fee	$24.56
SLC	$5.00	Switching	$4.12	Feature (Call Waiting)	$5.19
Directory Assistance	$0.86	Switch Feature	$0.00	SLC	$5.00
LNP	$0.23	DUF	$0.22	Directory Assistance	$0.86
Total	$35.84	Directory Assistance	$0.39	LNP	$0.23
		LNP	$0.23	Total	$35.84
		Total	$19.87		
				Long Distance	
				LD Revenue[5]	$14.00
				Access Revenue[6]	$2.52
Long Distance		RBOC avoided cost		Wholesale Cost[7]	$2.80
Access Revenue	$3.07	19.1% of retail[3]	$6.85	Net LD Revenue	$8.68
Total					
Grand Total	$38.91	Grand Total	$26.72	Grand Total	$44.52
		Revenue lost by RBOC[4]	$12.19	Revenue gained by RBOC	$8.68

Total Residential Lines[8] 7,655,000

Long Distance Market Share[9]		Local Market Share[10]	
VZ	40%	VZ	77%

Lost Local Lines[11]	1,760,650
Gained LD Lines[12]	3,062,000
Lost Local Revenue[13]	$ 21,462,324
Gained LD Revenue[14]	$ 26,578,160
Net Change in Revenue[15]	$ 5,115,837

Notes

1. Rates are based on New York Telephone tariffs. Line fee is an average of upstate and downstate message rates, assuming 1200 local originating minutes.
2. Computed using current UNE-P rates. Minutes of use are the same as for retail rates.
3. Avoided Cost percentage from NYT tariff.
4. Equals Grand Total, Local Retail - Total, Local Wholesale - RBOC Avoided Cost
5. WorldCom estimate. Assumes 140 minutes at 10 cents per minute.
6. Assumes Acces per minute of 1.8 cents, from July 2001 federal annual access tariff filing.
7. WorldCom estimate of 2 cents per minute.
8. 2001 ARMIS 43-08 data on total residential analog access lines
9. WorldCom estimate.
10. Table 6 of February 2002 edition of Local Telephone Competion: Status as of June 30, 2001
11. (1 - Local Market Share) * Total Residential Lines
12. Long Distance Market Share * Total Residential Lines
13. Lost Local Lines * Revenue Lost by RBOC
14. Gained LD Lines * Revenue Gained by RBOC
15. Gained LD Revenue - Lost Local Revenue

VERIZON COMMUNICATIONS, INC. August 21, 2002

NYSE :VZ Michael J. Balhoff, CFA mbalhoff@leggmason.com (410) 454-4842

RATING: B/2 Christopher C. King ccking@leggmason.com (410) 454-5775

VZ : COMMENTS ON RBOC WEAKNESS

Price (08/20/02)	$31.80				
S&P 500 Index (08/20/02)	937	FY Ends Dec	2001	2002	2003
52-Week Range	56 - 26	Revenue(MM)	$68,025.0	$67,224.0	$68,412.0
Shares Outstanding(MM)	2,751.7				
Book Value/Share	$0.00	**Earnings**			
Float Outstanding(MM)	2,670.0	1Q	$0.72A	$0.72A	NE
Market Capitalization(MM)	$87,504.1	2Q	$0.77A	$0.77A	NE
Enterprise Value(MM)	$147,626.5	3Q	$0.75A	$0.80E	NE
Avg. Daily Volume	8,109,970	4Q	$0.77A	$0.77E	NE
Projected 3Yr CAGR	13.0%				
LT Debt / Total Cap.	100.00%	**Fiscal Year EPS**	**$3.00A**	**$3.06E**	**$3.19E**
Net Cash / Share	$0.00				
Dividend	$1.54	EV/Revenue	2.2x	2.2x	2.2x
Yield	4.8%	P/E	10.6x	10.4x	10.0x
Target Price	$40.00				

All relevant disclosures appear on the last page of this report.

- **RBOC prices were off by 5% 7% yesterday after another investment firm issued a report downgrading the firm's rating to Hold on the shares of BellSouth (BLS), SBC Communications (SBC), and Verizon (VZ).**
- **The report was correct, in our view, in highlighting what was apparent in the most recent RBOC quarterly results, that is, UNE-P (unbundled network element platform) competition appears to be accelerating for SBC and BLS.**
- **We previously reported on the rapid growth of UNE-P usage, particularly in replacing resale, and we noted our concerns about WorldCom's flat-rate Neighborhood program in which the consumer can subscribe to all-you-can-eat local and long-distance services for $55 $60 per month; Neighborhood is financially possible only because the regulators have set such deep discounts on UNE-P and compelled the RBOCs to open their plant to this interconnection approach.**
- **We have also been making available to clients our detailed UNE-P sensitivity analysis that provides state-by-state data highlighting the RBOC revenue and earnings effects today and in an accelerating competitive marketplace.**
- **Our problem with the other firm's analysis is that it does not wrestle with the recent successes of Verizon in winning back customers, as Verizon can now offer the same bundle of local and long-distance products to 74% of its lines (the major states in the company's region).**
- **Further, the report couples together several dire predictions in suggesting that Verizon will have accelerating competition, followed by some greater sensitivity to earnings, precipitating potential downgrades in the company's debt ratings; our view is that Verizon has been coping with competition better than its RBOC peers (so an extreme change is possible but less likely), has been aggressively improving its balance sheet (including selling non-strategic assets), and is therefore not likely to have a major change to its credit ratings.**
- **Our rating on VZ remains Buy, based on our view that the stock is attractively valued, the company appears to have**

strongest set of RBOC assets, and our conviction that Verizon has the best relative competitive position in the industry.

The RBOC stock prices were down 5% 7% yesterday after another investment firm issued a report downgrading shares of BellSouth (BLS), SBC Communications (SBC), and Verizon (VZ), all to Hold from Buy.

The report stated the obvious that the RBOCs are currently under pressure from competitors that have increasingly benefited from low wholesale rates based on UNE-P (unbundled network element platform). We reported and have commented on the increased line loss to UNE-P in the 2Q02 results, as the competitors gained significant share particularly in the territories served by SBC and BellSouth. In fact, we have consistently reiterated that we believed there was additional downside potential in BLS and especially SBC, which is not as far along in the Section 271 process as its RBOC peers.

By way of background, the Bells' recent problems with UNE-P have grown as the Supreme Court, in May 2002, upheld the rights of the FCC and the rights of state commissions to set deep wholesale discounts for the entire set of RBOC services. WorldCom had also just announced its flat-rate local and long-distance Neighborhood product, a program that should impact 3Q02 RBOC results to an extent greater than in 2Q02. AT&T has also more aggressively targeted residential customers using UNE-P, gaining about 6% residential market share in Michigan (SBC's incumbent region) within 5 months. The UNE-P problem has also been exacerbated in states that have reduced rates even further as RBOCs have prepared their filings for in-region long-distance relief (Section 271). Notably, California reduced various rates sharply in May in preparation for SBC's filing which is likely in 3Q02 or early 4Q02 (see our SBC note on May 17, reducing earnings expectations after the California UNE-P rate cut).

We note that we prepared a UNE-P sensitivity model early this year and have been making it available to clients who have wanted to understand in detail how to analyze state-by-state UNE-P rates and their effects on RBOC revenues/earnings, both with respect to current competitive impact and the sensitivities that arise in accelerating UNE-P use.

Turning to the individual companies, we have previously reported that our ratings on SBC ($27.68, Hold) and BLS ($25.50, Hold) reflect our concerns about the competitive position of those companies, in part because UNE-P rates are likely to fall further in major states and because those companies are not yet able to respond to competitive attacks with a bundled local and long-distance service in the majority of their states. Again, we agree that UNE-P competition is likely to accelerate and that SBC and BellSouth are most exposed.

However, we disagree with the analysis of Verizon's position included in yesterday's report. The analyst acknowledged that Verizon (VZ, $31.80, Buy) is less exposed, but did not explain that Verizon has been effective in bundling local and long distance, and that the ability to combine products appears to be key in retaining and winning back customers. We note that our recent upgrade of Verizon to Buy from Hold occurred after 2Q02 results, and highlighted the stock's low valuation and reflected a change in our view of the company's competitive position, as Verizon appears to be coping with the competitive environment far more successfully than its peers whose 2Q02 results indicated deterioration in losses of lines to competitors. Verizon actually reported year-over-year winbacks in its UNE-P and resold customer base, and acknowledged that there was no acceleration in competitive losses in the first month of the third quarter. The report also does not disclose that much of the increase in UNE-P lines for all three carriers, and Verizon in particular, stems from a decline in resale lines, that is, wholesale lines simply migrating from resale to the more deeply discounted UNE-P product.

The key message, in our view, is that Verizon appears farther along in the competitive and regulatory processes, and we believe that this permits the company to contend better than the other RBOCs with alternative products; that is, Verizon is able to offer long-distance services to 74% of its in-region Bell lines by contrast with BellSouth and SBC, which can offer those services to a minority of their lines, 27% and 29%, respectively.

We recognize that Verizon may experience more competition in the future, but the company appears to be better positioned to respond in the near term, in our opinion, and has fewer jurisdictions in which UNE-P rates are likely to be reduced further in the next months (possibly West Virginia, DC, Virginia and Maryland), while the company's largest states have previously set UNE-P rates and Verizon has competitive bundled services in effect.

The other negative highlighted by the report, in our view, is that Verizon is more leveraged than the other RBOCs so that relatively fewer losses in lines/profitability could result in more volatility for the company's equity valuation, with the greater likelihood that the company's credit ratings could be affected. The report suggests a scenario that could prove true, but has assumed the most dire set of circumstances, involving extreme line losses and no significant change in the company's balance sheet; we note that Verizon has been aggressively paying down debt, including $3.3 billion of net debt in the most recent quarter, and has non-strategic assets that can and likely will be liquidated. Finally, the company has been competing relatively well and is reporting no material shift in competitive position.

We note that our VZ upgrade was premised on a valuation argument (4.8x EV/ 2003 EBITDA and 10.0 P/E) rather than expectation for material growth; our target price of $40 implies a 5.5x EV/2003 EBITDA multiple, which is a 23% discount to the S&P 500 P/E multiple. The upside potential is particularly attractive in light of Verizon's current dividend yield of 4.8%; even assuming no growth, we believe there is relatively little downside potential from current levels as we estimate that a no-growth scenario would merit an EV/EBITDA multiple of approximately 4.5x.

Summary

In summary, we believe that the other firm's report is correct in its general outlines that UNE-P competition is expanding and is hurting SBC and BellSouth at the present; it is wrong, in our view, in failing to properly evaluate Verizon's competitive strengths and the opportunities for the company to avoid credit difficulties; we continue to maintain our Buy rating on VZ shares and Hold ratings on SBC and BLS shares.

Company Description

Verizon Communications is one of the world's leading providers of communications services. Verizon companies are the largest providers of wireline and wireless communications in the United States, with 135.1 million access line equivalents and 30.3 million Verizon Wireless customers. Verizon is also the largest directory publisher in the world. With more than $67 billion in annual revenues and approximately 241,000 employees, Verizon's global presence extends to more than 40 countries in the Americas, Europe, Asia and the Pacific.

Investment Rating: B-Buy H-Hold S-Sell
Risk Rating: 1-Low 2-Average 3-High

the next 12 months. A Hold rating is also used for those higher-yielding securities where we are comfortable with the safety of the dividend, but believe that upside in the share price is limited. SELL - We expect this stock to underperform the S&P 500 by more than 10% over the next 12 months and believe the stock could decline in value. We also use a Risk rating for each security. The Risk ratings are Low, Average, and High and are based primarily on the strength of the balance sheet and the predictability of earnings.