LAWLER, METZGER & MILKMAN, LLC

2001 K STREET, NW
SUITE 802
WASHINGTON, D.C. 20006

RUTH MILKMAN
PHONE (202) 777-7726

PHONE (202) 777-7700
FACSIMILE (202) 777-7763

November 15, 2002

BY ELECTRONIC FILING

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

Re: *Ex Parte Presentation*
In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers,
CC Docket Nos. 01-338, 96-98, 98-147

Dear Ms. Dortch:

On November 14, 2002, Michael Pelcovits, Principal, Microeconomic Consulting and Research Associates, consultant to WorldCom, Inc. ("WorldCom"), and A. Richard Metzger, Jr., counsel to WorldCom, met with Barbara Cherry, Donald Stockdale and Simon Wilkie of the Office of Plans and Policy to discuss the attached presentation. In addition, on November 15, Christopher Fentrup, Senior Economist, WorldCom, Dr. Pelcovits, and Mr. Metzger met with Matthew Brill, Senior Legal Advisor to Commissioner Abernathy. In addition to discussing the attached presentation during the meeting with Mr. Brill, Dr. Pelcovits and Messrs. Fentrup and Metzger also discussed the *ex parte* letter from Donna Sorgi, Vice President, Federal Advocacy, WorldCom to Chairman Powell, filed in the above-captioned dockets on September 16, 2002.

Pursuant to section 1.1206(b)(2) of the Commission's rules, 47 C.F.R. § 1.1206(b)(2), this letter is being provided to you for inclusion in the public record of the above-referenced proceeding.

Sincerely,

Ruth Milkman

Ruth Milkman

cc: Barbara Cherry
Donald Stockdale
Simon Wilkie
Matthew Brill

The Effect of UNE-P Competition on the RBOC's Financial Health

Michael D. Pelcovits, Ph.D.
Microeconomic Consulting & Research Associates, Inc.

This paper presents a sensitivity analysis of the potential financial impact on the RBOCs of UNE-P competition in local markets, coupled with their own entry into long distance markets. The analysis will quantify the possible effect on the RBOCs' earnings from these two changes in the marketplace. In order to provide perspective on the new risks faced by the RBOCs, the analysis will also compare these prospective risks to the historic risk that their stockholders have faced in the last eight years from all other sources. We reach two conclusions. First, the profit opportunity from long distance entry equals or exceeds the risks from CLEC entry into local markets. Second, the additional uncertainty faced by the RBOCs is small relative to historic risks.

Model Assumptions

Companies Studied: The three remaining pure RBOCs were studied: Verizon (VZ), Bell South (BLS), and SBC.

Period of time: The analysis compares the financial condition of the companies in second quarter 2002 to a single point in the future, roughly corresponding to 2005 or 2006. The analysis assumes that each of the RBOCs will lose 20% of their residential customers to UNE-P competitors by this later date. The estimate of future CLEC market share is optimistic in our view and represents an upper bound of projected lost market share. A corresponding estimate would be the 18.62% line loss by 2006, contained in the UBS Warburg analysis (August 20, 2002).

Revenue: Average revenue from acquiring a residential retail customer includes: basic local service, SLC, vertical services, access, intraLATA toll, and USF. Our estimate is based on the UBS Warburg report. UNE-P revenue is also based on Warburg, although we believe this underestimates UNE-P revenues the RBOCs actually are receiving.[1] This assumption leads to an overestimate of the downside risk facing the RBOCs. Average retail long distance revenue per customer is conservatively assumed to be $12.00 per month, again based on the UBS Warburg report and the Legg Mason report of October 8, 2002. *Table 1* displays the Monthly Revenues per Customer used in this model:

[1] This is primarily due to an underestimate of the number of UNE switching minutes per month purchased by competitive local exchange carriers (CLECs).

RBOC	Retail Revenue	UNE-P Revenue
Bell South	36.72	18.43
SBC	34.25	14.50
Verizon	32.99	15.10

Table 1: *Monthly Revenues Per Customer*

Profit Margin on Local: The profit lost by the RBOC when it loses a retail customer equals the change in revenue minus the change in cost. The cost saved by the RBOC when it loses a retail customer is assumed to be 10% of retail revenues. We believe this is a conservative assumption in light of the fact that the resale discount set by many states is much closer to 20%.[2]

Profit Margin on Long Distance: The profit margin on long distance is assumed to be 45%. UBS Warburg and Legg Mason assume a 35% margin. WorldCom has provided a detailed estimate projecting a 59% margin on long distance for the RBOCs.[3] We expect the RBOCs to earn a margin closer to the WorldCom projection, because they benefit from a very low cost of marketing long distance to their existing local customer base. Nevertheless, we have used a number closer to the Wall Street analysts' to yield a conservative estimate.

Trade ratio: This refers to the ratio of long distance customers gained by the RBOC to the local retail customers lost to UNE-P, after several years have elapsed and local and long distance markets have adjusted to the new entrants. Because the financial projections are so highly sensitive to this ratio, we estimate "High" and "Low" bounds for the financial impact of competition and long distance entry on the RBOCs. The High estimate is based on a 4-to-1 ratio of long distance gains to local losses. The Low estimate is based on a 2-to-1 ratio. The only Wall Street report we have seen that projects a trade ratio for the next few years is Legg Mason, which estimates a 4-to-1 exchange. Once again, we are making conservative assumption to assess the downside risk that the RBOCs are facing.

Excluded Factors: The analysis does not consider any other factors affecting the financial condition of the RBOCs. The goal of the study is to conduct a *ceteris paribus* analysis, where all other factors are considered unchanged in order to allow us to isolate the effects of UNE-P and long distance entry.

[2] It would not change our estimates materially if we used the cost saving of approximately 6% to 7% found in the UBS Warburg report.

[3] Letter of Donna Sorgi, Vice President Federal Advocacy, WorldCom to Chairman Michael K. Powell, re: CC Docket No. 01-338, September 16, 2002, Attachment A, page 5.

Calculations: The model estimates the change in EBITDA from the loss in local retail customers and gain in long distance customers, for each of the RBOCs. The calculation relied on is:

*Monthly Change in EBIT= [# Residential Lines * .2][-Margin Lost on Local + (Margin Gain in Long Distance * Local to Long Distance Gain Ratio)]*

Where:

Margin Lost on Local= [(Retail Revenue Per Line) (1 –Retail Cost Saving)] – UNE-P Revenue Per Line*

*Margin Gain in Long Distance= Long Distance Revenue per Line * Long Distance Margin*

As stated above, the model estimates a "High" case, where the trade ratio is 4:1, and a "Low" case, where the trade ratio is 2:1. For each case, the impact on earnings is calculated by reducing EBITDA for corporate taxes at a 36% rate. The results for the three RBOCs are shown in *Table 2* below.

RBOC	High EBIT	Low EBIT	High Earnings	Low Earnings
BellSouth	66,093,008	-36,141,952	42,299,525	-23,130,849
SBC	104,976,720	-109,951,920	67,185,101	-70,369,229
Verizon	154,531,628	-83,582,452	98,900,242	-53,492,769

Table 2: *Quarterly EBIT and Earnings Results*

Explanation of Results

The potential for change in the residential market created by the Telecommunications Act of 1996 is substantial. The RBOCs' large margins on residential service are put at risk by competition from CLECs – whether they use UNE-P or their own facilities to compete. Indeed, the RBOCs would be much worse off if the CLECs used their own facilities rather than UNE-P. On the other hand, the RBOCs have the opportunity to earn significant profits from selling a new service – long distance – which is easily marketed to their existing customer base. As shown in the table above, the opportunity or risk from these changes could create a swing in the quarterly earnings of the RBOCs amounting to tens of millions of dollars. For two of the RBOCs, Bell South and Verizon, the opportunity for increased profits is greater than the risk of decreased profits. For SBC the risk of decreased profits is slightly greater than the opportunity for increased profits.

The RBOCs may nevertheless claim that the increased uncertainty they face will make it more difficult to attract new capital or persuade existing shareholders to fund new investment. To respond to this concern, we have analyzed the trend of market capitalization of the three RBOCs over the last several years. Market capitalization is the total value of a company's stock market equity, and is calculated by multiplying the share price at any point in time by the number of outstanding shares of the firm. The impact of competition on the market capitalization of the RBOCs, based on the results of the model, is estimated by multiplying the "high" and "low" earnings impact by the current price-earnings multiple. This is a conventional way to estimate the effect of changes in earnings on the stock price.[4] We have chosen to look at stock prices and market capitalization, because this provides a good barometer of the market's appraisal of the financial condition of a firm, and also informs us about the ability of the firm to raise capital.

Table 3 reports several statistics about the market capitalization of the three RBOCs. The estimates of the change in market capitalization from competition are shown, along with the current market cap, the mean market cap for the last eight years, and the standard deviation of monthly market cap over this period. Standard deviation is a measure of variation in a data series. In very simplified terms, a data point will lie within one standard deviation of the mean about two-thirds of the time.

	In Millions						
RBOC	**Nov 2002 Market Cap**	**Mean**	**Standard Deviation**	**High Change in MKT Cap**	**Low Change in MKT Cap**	**High Change as % of MKT Cap**	**Low Change as % of MKT Cap**
BellSouth	47,691	54,763	20,610	2,064	-1,129	4.3%	-2.4%
SBC	85,354	106,788	39,126	3,262	-3,417	3.8%	-4.0%
Verizon	101,497	107,120	30,500	5,091	-2,754	5.0%	-2.7%

Table 3: *Market Capitalization Statistics*

What this analysis reveals is that the change in market cap derived from the competition model is at worst about 4% of the current market cap. By contrast, the "normal" month-to-month variation in the market cap of the RBOCs creates a distribution with a standard deviation of 30-38% of the mean. Put as simply as possible, UNE-P competition accompanied by long distance authority, exposes the RBOCs to a very modest level of additional risk relative to the historical variation in their market capitalization.

Another way to portray the additional risk faced by the RBOCs from UNE-P and long distance entry is to chart their historic market capitalization and estimate a simple trend line. We have done this for each of the RBOCs, and the attached charts show the monthly value of their market caps and the trend line drawn through those points and extended for three years. The impact of UNE-P and long distance entry is shown by two dotted lines drawn parallel to the trend line for the future period. The dotted line above the trend line represents the "high" case; the dotted line above represents the "low"

[4] We have assumed that the price-earnings ratio does not change.

case.[5] Hence, the chart is showing a maximum impact from competition during all future periods. The chart also shows two other, wider parallel solid lines that represent the standard error in the trend line.

These charts show that investors face significant inherent risk about future stock prices and market capitalization of the RBOCs. Using standard statistical tools and assumptions, we can attach a 66% probability that the future market cap will fall within the wide lines labeled "normal variation." By comparison, the additional uncertainty created by UNE-P competition coupled with long distance entry is barely noticeable. This confirms that the impact of competition is within the normal risk faced by the stockholders of these firms, and will not compromise the ability of the RBOCs to raise capital.

Conclusions

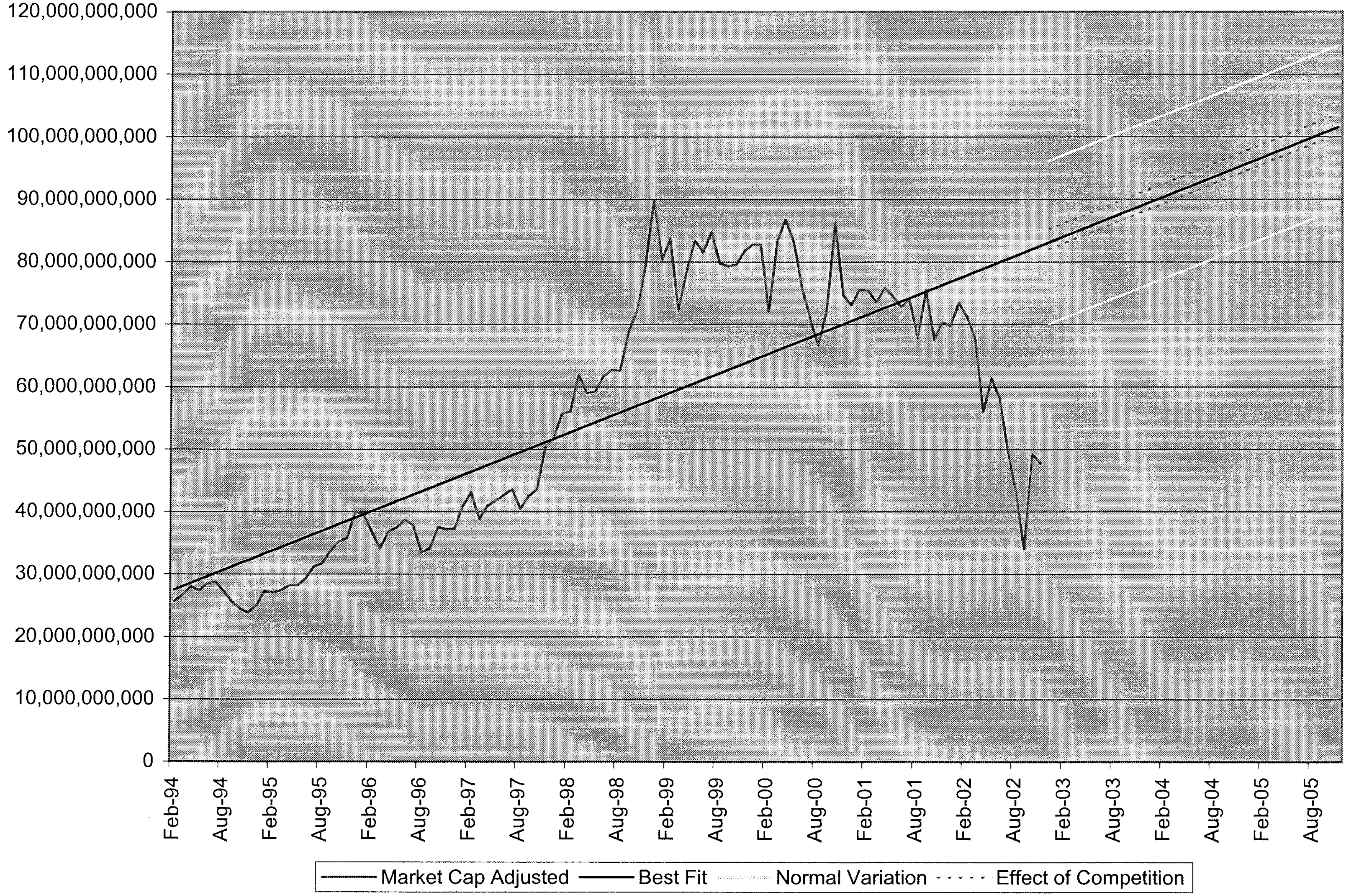
This analysis refutes the RBOCs' claim that UNEP-based local competition constitutes an unprecedented threat to their financial stability. While competition introduces new risks for incumbent monopolists, the RBOCs have the opportunity to earn profits from a major new line of business. This paper demonstrates that the risks and opportunities faced by the RBOCs are in rough balance. More importantly, however, we have demonstrated that the downside risk faced by the RBOCs is very small relative to the normal variations in earnings and earnings expectations that cause frequent wide swings in their stock prices and company valuations. Specifically:

- Even if the RBOCs lose 20% of their local residential customers to UNEP, and they are only modestly successful in the long distance market, the impact on their stock prices (and market capitalization) would be no worse than a 4% decline.
- The risk of a 4% swing in stock price should be put in perspective. Over the past eight years, the market capitalizations of the RBOCs have typically experienced swings of 30% to 38% in value.

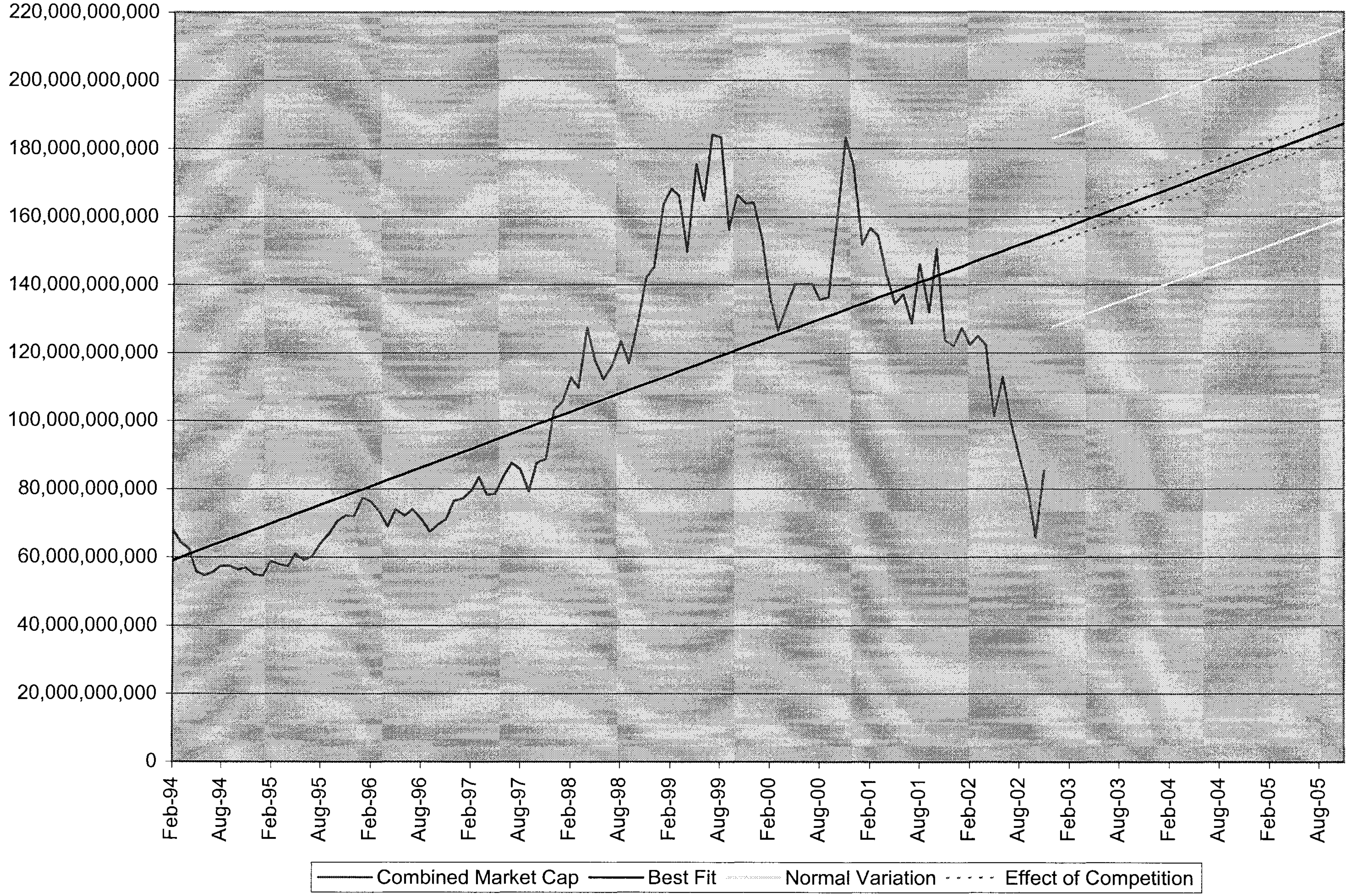
November 12, 2002

[5] The line is drawn parallel to the trend line, by shifting the intercept of the line by an amount equal to the "high" and "low" change in market cap. This shows the extent of additional uncertainty in earnings that can be expected after the markets have matured – in about three or four years. Prior to that time, the uncertainty would not be as great, because neither the CLECs' nor ILECs' market shares would have leveled off.

BellSouth Market Cap Analysis



SBC Market Cap Analysis



Verizon Market Cap Analysis