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November 26, 2002

By Electronic Filing

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th St., S.W.
Washington, D.C. 20554

Re: Application by SBC Communications Inc., Pacific Bell Telephone Company, and Southwestern Bell Communications Services, Inc., for Provision of In-Region, InterLATA Services in California; WC Docket No. 02-306 – Ex Parte Filing

Dear Ms. Dortch:

On behalf of AT&T Corp. ("AT&T"), this letter and the attached declarations of Michael Lieberman, Brian Pitkin and Terry Murray address several pricing arguments raised by Pacific Bell in its November 4, 2002 reply comments in the above-captioned proceeding. As detailed below and in the attached declarations, the existing record, more recent events and Pacific's own admissions confirm that Pacific has fallen far short of its burden to demonstrate that its interim California network element rates are cost-based and nondiscriminatory and support a finding that Pacific's local markets are irreversibly open to competition. Indeed, Pacific's most recent admission confirms that its interim rates must be disregarded altogether because those rates are part and parcel of Pacific's overall "bait and switch" strategy to more than double its rates soon after it obtains section 271 authority.

Unlike prior successful section 271 applicants, Pacific has conceded that virtually *none* of its recurring loop rates or recurring switching rates are the product of a TELRIC-compliant cost study. *See* Vandeloop Reply Decl. ¶ 5 ("AT&T is correct that Pacific's interim rates were not themselves based on any rigorous application of TELRIC"). Pacific responds that, although the current interim loop and switching rates were not set using TELRIC-principles, they are nevertheless TELRIC-compliant because those rates are discounts to rates that "were originally in accordance with TELRIC principles." *See id.* But that is a *non sequitur*. The California Public Utilities Commission ("CPUC") has expressly determined that the original

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rates in California – which are based on 1997 cost studies that used 1994 data – are no longer TELRIC-compliant. *See, e.g.*, CPUC Decision 02-05-042, at 5-6 (May 16, 2002). Indeed, that is precisely why the CPUC opened the new UNE rate proceeding in which interim rates were adopted.¹ Thus, it does not follow, as Pacific argues, that reductions to the original California rates automatically produce TELRIC-compliant rates.²

In fact, the CPUC has confirmed that the reductions to Pacific’s interim rates are *not* sufficient to bring those rates within the range that a reasonable application of TELRIC principles would have produced. Specifically, the CPUC has explicitly acknowledged that the interim rates do not address important TELRIC errors that inflate Pacific’s original California rates. As one example, the CPUC agreed that the record in the California state proceedings showed that Pacific’s loop expenses had declined substantially since 1994, but did not reflect those reductions in the interim rates, noting that “[b]ecause we are setting interim rates that will be subject to true-up, we will use a conservative approach” and not account for expense declines in the interim rates.³ The CPUC has committed to “explore further [the declines in loop expenses] when . . . set[ing] final rates for loops.”⁴ On this record, there can be no reasoned finding that Pacific’s interim rates are TELRIC-compliant.⁵

Pacific invites the Commission to approve its California application notwithstanding the lack of any TELRIC support for the existing interim rates based on a

¹ *See also* AT&T at 14-16.

² The current interim rates in California are the result of the CPUC’s attempt to address Pacific’s “delaying tactics” in the ongoing UNE rate proceeding to update Pacific’s California UNE rates. Specifically, because Pacific refused to comply with direct CPUC orders to file new TELRIC-compliant cost studies, the CPUC was forced to delay its UNE rate proceeding and adopt interim rates, which the CPUC conceded failed to fully account for the cost declines in California since Pacific’s rates originally were set. *See* AT&T at 15-19 (summarizing the CPUC’s decisions).

³ CPUC Decision 02-05-042, at 39 (May 16, 2002) (“*CPUC Interim Rate Order*”).

⁴ *Id.* at 40.

⁵ The fact that Pacific’s original rates are not TELRIC-compliant and that the interim reductions to those rates are concededly insufficient to bring those rates within TELRIC-compliance obviously eliminates any need for commenters in this proceeding to raise the myriad additional TELRIC errors that inflated the old rates based upon the 1997 cost studies and 1994 cost data. Nevertheless, the comments confirm that Pacific’s rates also are inflated by multiple other clear TELRIC violations that preclude any finding that Pacific’s rates comply with checklist item two, and as explained in the attached declaration of Terry Murray, Pacific has no legitimate response to these showings.

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benchmark comparison to Texas rates. The Commission must decline that invitation. The record shows that Texas rates also are not TELRIC-compliant, and, in any event, that Texas and California have substantially different rate structures and geographic characteristics. *See, e.g., AT&T at 19-26.* The attached joint declaration of Michael Lieberman and Brian Pitkin responds to Pacific Bell's attempts to defend that inappropriate benchmarking analysis.

But even if Texas rates were an appropriate benchmark, the fact that Pacific's interim rates might pass a benchmark comparison to the permanent Texas rates is irrelevant, because Pacific does not intend to make those interim rates (or rates that bear any resemblance to the interim rates) available to CLECs after Pacific obtains section 271 approval. Indeed, although Pacific filed cost studies with the CPUC in August 2001 showing that appropriate UNE rates in California should be about 20-30 percent higher than the interim rates adopted by the CPUC, Pacific has now filed new cost studies with the CPUC claiming that its recurring loop and switching rates should be *more than double* the existing interim rates. According to Linda Vandeloop, a Pacific executive and a witness in this proceeding, Pacific "was willing to temporarily go along with lower rates to speed its application to enter the long-distance market in California, figuring it could argue for higher permanent rates later." Todd Wallack, *Pac Bell takes aim at rivals; Request seeks to raise lease fees for lines*, San Francisco Chronicle (November 15, 2002).⁶ In other words, Pacific has implemented a "bait and switch" strategy, whereby Pacific hopes to obtain support for its section 271 application from the CPUC, and approval from this Commission, based on one set of rates, and then plans to more than double those rates after obtaining such approval. *Id.* Thus, even if Pacific's sham interim rates could pass a benchmarking test today, that would be meaningless to the Commission's determination of whether Pacific's markets are irreversibly open to competition.

The record shows that Pacific's strategy from day one has been to retain its ability to foreclose local telephone competition in California by establishing above-TELRIC UNE rates. Pacific's strategy began with its multiple "delaying tactics" to thwart the CPUC's ability to implement permanent TELRIC-compliant UNE rates in California. That strategy succeeded, and the CPUC found that SBC's delay tactics in producing verifiable cost models ultimately forced it to adopt stop-gap interim rates, which continue to be substantially above TELRIC levels and left the door open for Pacific to seek higher permanent rates in the future. More importantly, the interim rates provided Pacific with cover in its section 271 bid – Pacific could now (and did)

⁶ Available at <<http://www.sfgate.com/cgi-bin/article.cgi?file=/chronicle/archive/2002/11/15/BU154436.DTL&type=business>>. SBC's chairman also has effectively admitted that it purposefully engaged in these types of tactics. *See* Los Angeles Times, *For SBC's Chairman, a Distance to Go Ed Whitacre discusses the phone firm's frustrations as it seeks to expand in California* (October 28, 2002) ("Q: When California set new interim wholesale rates this year, regulators said you defied orders to provide them with cost data. So how can you now complain that current prices don't reflect your costs? A: I won't say we're totally blameless in this, but they have cost data now.").

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argue that this Commission should rubber stamp its application based on those interim rates. After obtaining section 271 approval, however, Pacific will demand that the CPUC more than double those interim rates to levels similar to Pacific's original rates – rates that the Department of Justice has determined to have significantly contributed to the lack of UNE-based entry in California.⁷

Pacific cannot deny these facts. As noted above, Pacific's own executives have admitted Pacific's intent to obtain section 271 approval based on the interim rates, and then to subsequently seek higher rates. Indeed, Pacific is advocating rate levels in the permanent cost proceeding that are at least *twice* as high as the current interim rates. At the same time, SBC, Pacific's parent company has already begun threatening the CPUC with significant job cuts if it does not accede to its demands for higher rates. See SBC Investor Report at 16 (attached to Lieberman/Pitkin Supp. Decl.) (explaining that SBC will implement an "11,000 [labor] force reduction" and that "[c]uts [will be] proportionately greater in states with lowest UNE-P [rates]").

In sum, there is no reasonable basis for the Commission to rely on Pacific's interim rates to find that California local telephone markets are open to competition and will remain so in the future, because the interim rates upon which Pacific relies are, by Pacific's own admission, a sham. And, in all events, the record in this proceeding confirms that Pacific's California interim rates are inflated above levels that any reasonable application of TELRIC principles would produce, and that Pacific's rates cannot be approved based on a benchmark to Texas, because (1) Texas is not an appropriate benchmark state and (2) the California rates used in Pacific's analysis are far below those that Pacific intends to charge competitors after Pacific gains section 271 authority.

Respectfully submitted,

/s/ Christopher T. Shenk
Christopher T. Shenk

Attorney for AT&T Corp.

Enclosures

⁷ DOJ at Eval. at 7.

EXHIBIT 1
LIEBERMAN/PITKIN SUPP. DECL.

**BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554**

In the Matter of

Application of SBC Communications Inc.,)	
Pacific Bell Telephone Company, and)	WC Docket No. 02-306
Southwestern Bell Communications)	
Services, Inc. for Provision of In-Region,)	
InterLATA Services in California)	
)	
)	

**SUPPLEMENTAL JOINT DECLARATION OF
MICHAEL R. LIEBERMAN AND BRIAN F. PITKIN
ON BEHALF OF AT&T CORP.**

I. BACKGROUND AND SUMMARY

1. Our names are Michael R. Lieberman and Brian F. Pitkin. We are the same Michael R. Lieberman and Brian F. Pitkin who filed a joint declaration with AT&T's initial opposition to Pacific's Section 271 application. In our initial testimony, we demonstrated that Texas rates cannot legitimately be used in the Commission's short cut benchmarking test to justify rates in California, because Texas does not satisfy *any* of the criteria that the Commission has recognized are critical to choosing a benchmark state. Specifically, we demonstrated that (1) Texas rates are not TELRIC-compliant; (2) the rate structures in Texas and California are not sufficiently similar to allow for meaningful rate comparisons; (3) there are substantial differences in geography between Texas and California that make rate comparisons between those states less meaningful; and (4) Texas and California were served by different BOCs at the time the rates were developed in those states. The purpose of our supplemental declaration is to respond to the baseless criticisms of our those showings advanced by Pacific.

II. PACIFIC'S CLAIM THAT TEXAS RATES ARE TELRIC-COMPLIANT IS CONTRADICTED BY THE STATEMENTS OF THE TEXAS PUBLIC UTILITIES COMMISSION.

2. As explained in my initial testimony, the Commission's benchmarking test is a short-cut method for assessing whether rates in an applicant state are TELRIC-compliant. If the cost-adjusted rates in the applicant state are lower than the cost-adjusted rates in a state where rates that are known to be TELRIC-compliant (the "benchmark" state), then it is logical to presume that the rates in the applicant state also are TELRIC-compliant. A critical characteristic of the benchmark state, therefore, is that the rates in the benchmark state are TELRIC-compliant. As explained by the Commission, "without a finding of TELRIC compliance for the benchmark state, a comparison loses all significance."¹

3. Pacific concedes, as it must, that the Texas Public Utilities Commission ("TPUC") has expressly recognized that the Texas rates, which are based on 1996 and earlier data do not reflect the substantial costs changes that have occurred since then.² Indeed, the TPUC has expressly stated that "the evidence show[s] that SWBT's deployment of Project Pronto has changed loop plant technology, technology mix, and processes regarding loop deployment and maintenance" and that "[t]here is also evidence that engineering assumptions (such as higher percentage of the use of remote terminals and fiber feeder) have changed as a result of Project Pronto[.]. . . [which] has caused the use of more fiber, declining cost of electronics, lower cost structure for NGDLC, and a reduction of the number of dispatches and maintenance processes and *lower overall costs*."³ The TPUC thus concluded that [t]he evidence

¹ *Pennsylvania 271 Order* ¶ 67.

² Makarewicz Decl. ¶ 15.

³ *Texas 2002 Arbitration Order*, at 110 (emphasis added).

of such changed circumstances is sufficiently compelling to merit and investigation of SWBT's forward-looking loop costs and, therefore, the UNE rates."⁴

4. Moreover, the TPUC has expressly *rejected* SBC's baseless claims that current Texas rates are cost-based. As explained by TPUC, "there was insufficient evidence introduced by SWBT . . . to conclude that the current rates, based on the previous cost studies and data from the 1996 Mega-Arbitration, are appropriate"⁵ and that "there is inadequate evidence to support the assertion that assumptions built into the 1997 Mega-Arbitration cost studies sufficiently address current deployment."⁶

5. Unable to deny the TPUC's clear findings, Pacific's witness states that, based on these statements, "one cannot make the automatic assumption that costs have decreased."⁷ As a preliminary matter, even if it were not clear whether SBC's Texas rates had increased or decreased over the past 5 to 10 years, then there is no basis for the Commission to rely on SBC's existing, and outdated, Texas rates in its shortcut benchmarking analysis.

6. In any event, Pacific's assertion that SBC's Texas costs may have increased since 1997 is absurd, and is contradicted by SBC's own financial reports, by "fact reports" submitted by SBC's attorneys in other proceedings, and by the findings of other state Commission's. On October 4, 2002, SBC released an "Investor Update" relating to its "2002 Q3 Earnings."⁸ That report shows that Pacific's Cash Operating Expenses have fallen by between 3 percent and 5.8

⁴ *Texas 2002 Arbitration Order*, at 110.

⁵ *See id.*

⁶ *See id.*

⁷ Makarewicz Decl. ¶ 15.

⁸ *See* Attachment A, hereto ("SBC Investor Report").

percent in every Quarter in 2002.⁹ The report also shows that in the past year the combined effect of SBC's recent labor reductions and other non-labor cost controls has reduced SBC's wireline expenses by \$150 million.¹⁰ In addition, SBC's capital expenditures have fallen by nearly \$1 billion in the past year. And the report promises to continue this "cost discipline" through "sustained productivity improvements" and controlled "cap[ital] ex[penditures]."¹¹ SBC's own report to its investors, therefore, contradict SBC's claims that its costs have *increased* since they first were developed.

7. SBC's concession relating to declining costs in its investor report are substantiated by a "fact report" filed by its attorneys in another proceeding.¹² A "Fact Report" authored by SBC's attorneys on behalf of SBC and other BOCs states that "[c]osts have been driven down rapidly by advances in digital technology" and that "on a per-line basis, prices have declined by 60 percent from 1986 to 1996 and were projected to fall another 12 percent by 2000."¹³ Given these concessions, SBC's witness' claims that SBC's costs in Texas have increased are clearly erroneous.

8. Finally, SBC's assertions that Texas costs have increased since 1998 are refuted by the findings of other state commissions. It is our understanding that in every other state in the country where state commissions have conducted intensive new UNE rate proceedings to replace rates developed between 1996 and 1998, the state commission has determined that the forward-

⁹ The report shows reductions in the first quarter of 2002 of 5.8%, in the second quarter of 2002 of 4.2% and in the third quarter of 2002 of 3%. See SBC Investor Report at 24.

¹⁰ See SBC Investor Report at 25.

¹¹ See SBC Investor Report at 29.

¹² See Peter W. Huber & Evan T. Leo, UNE Fact Report, Submitted by the United States Telephone Association, Prepared for Ameritech, BellAtlantic, BellSouth, GTE, SBC, and US WEST (May 26, 1999), at I-28, attached to Comments of United States Telephone Association, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996; Interconnection Between Local Exchange Carriers And Commercial Mobile Radio Service Providers*, CC Docket No. 96-98, Tab 3 (filed May 26, 1999).

looking costs of both loop and nonloop have declined dramatically. Some examples include (1) New York, where the state commission updated Verizon's 1997-based loop and nonloop rates with rates that are 18% and 42% lower; (2) New Jersey, where the state commission updated Verizon's 1997-based loop and nonloop rates with rates that are 41% and 61% lower; (3) Colorado, where the state commission updated Qwest's 1996-based loop and nonloop rates with rates that are 56% and 36% lower (and it is our understanding that parties in the ongoing Qwest 271 proceedings have shown that even those reduced rates are still above TELRIC levels); and (4) California, where the state commission determined that Pacific's 1996 loop and nonloop costs have fallen dramatically (by 36% and 69%, respectively). On this record, Pacific's assertion that one cannot conclude that the costs for UNEs in Texas have declined since 1996 based on the TPUC's findings exceeds the bounds of credulity, particularly given the TPUC's decision to reconsider SWBT's Texas rates given SWBT's "use of more fiber, declining cost of electronics, lower cost structure for NGDLC, and a reduction of the number of dispatches and maintenance processes and *lower overall costs.*"¹⁴

9. Lacking any legitimate response to the fact that Texas rates cannot be used as a benchmark because they are no longer TELRIC-compliant, Pacific (inappropriately) parrots prior Commission section 271 Orders and the D.C. Circuit for the proposition that rates need not be fully up-to-date. But the problems in Texas fall outside of the safe harbor offered by the D.C. Circuit and later relied upon by the Commission. In the New York decision, the D.C. Circuit correctly explained that state commissions cannot be expected to ensure that UNE rates are compliant with up-to-the-minute TELRIC principles. Rather, the D.C. Circuit noted that there might be an acceptable three to four year lag, during which rates set in a particular state may be

¹³ *Id.* at I-28.

sufficiently close to current TELRIC-standards, such that it may be appropriate for the Commission to rely on those older rates. In this regard, it is my understanding that the D.C. Circuit did not mean that rates, no matter how outdated, can be relied on by the Commission.

10. The rates in Texas fall outside the three to four year lag referred to by the D.C. Circuit in its New York Decision. The rates in Texas are based on 1997 cost studies, which were themselves based on 1996 and earlier data. Therefore, the Texas rates are over 5 years old. Thus, Texas rates are far more outdated than we understand the D.C. Circuit found to be reasonable, making it inappropriate for Pacific to rely on that decision for the proposition that the Commission can reasonably rely on such outdated rates.

11. Moreover, as explained in AT&T's reply comments, the D.C. Circuit's Massachusetts decision has fine tuned its analysis in a way that further confirms that Texas is not an appropriate benchmark state. In that case, WorldCom challenged Verizon's reliance upon a New York benchmark to justify its Massachusetts rates. WorldCom argued that the New York benchmark had "become radically detached from TELRIC" as a result of, *inter alia*, "the age of the rates."¹⁵ The Court expressly recognized that "[a]t some point, WorldCom's argument plainly must become a winner" – "ancient UNE rates cannot serve as a valid benchmark" and it "is surely right . . . that a challenger might tender evidence of benchmark unreasonableness so strong as to preclude FCC approval without a hearing" on the reasonableness of the rates tendered as benchmarks.¹⁶ AT&T has tendered just such evidence here – as demonstrated in my initial joint declaration with Brian Pitkin, regardless of the measure, SWBT's Texas rates are

¹⁴ *Texas 2002 Arbitration Order*, at 110 (emphasis added)

¹⁵ *Id.*

¹⁶ *Id.* at 5.

vastly above current TELRIC levels. And, as demonstrated herein, Pacific has offered no legitimate evidence to controvert those showings.

12. Thus, Pacific's claim that the Commission can turn a blind eye to the outdated Texas rates, and use those rates as a benchmark for assessing California's rates is *not* supported by the D.C. Circuit or by the Commission's prior orders. On the contrary, the D.C. Circuit's prior decisions preclude the use of Texas as a benchmark state in this proceeding.

III. PACIFIC'S CLAIMS THAT NEITHER THE COMMISSION'S COST MODEL, NOR SBC'S OWN DATA CAN BE USED TO MEASURE COST DECLINES IN TEXAS ARE BASELESS.

13. In our initial joint declaration, we demonstrated that the Commission's Synthesis Cost Model shows that SBC's forward-looking costs of providing loops and switching in Texas have declined by at least 29% and 33% respectively.¹⁷ We also demonstrated that the data reported by SBC in its ARMIS reports confirms that SBC's Texas loop and switching costs have declined dramatically since 1996 – by at least 28% and 18%, respectively.¹⁸ Pacific offers no legitimate response to these showings.

A. Pacific's Criticisms Of AT&T's Synthesis Cost Model Analysis Are Baseless.

14. The Commission's Synthesis Cost Model is designed to measure relative forward-looking costs of providing local telephone services. Based on runs of the Commission's Synthesis Cost Model using both 1996 and 2001 line count and dial equipment minutes ("DEMs") data, it is clear that SWBT's Texas forward-looking loop and switching rates have declined by at least 29% and 33%, respectively.¹⁹ This analysis confirms that Texas is not an

¹⁷ See Lieberman/Pitkin Decl., Table 1.

¹⁸ See *id.*, Table 2.

¹⁹ See *id.*, Table 1.

appropriate benchmark state, because SWBT's Texas rates do not reflect these (and other) cost declines in Texas.

15. Pacific claims that this analysis is flawed because it accounts for only changes in line counts and DEMs between 1996 and 2001, and does not account for *all* changes to loop and switching investments between 1996 and 2001. But that analysis is the same analysis that the Commission uses when it updates the Synthesis Cost Model each year for computing relative costs differences among states to determine the level of universal service support and contribution levels. Specifically, each year the Commission updates the Synthesis Cost Model to reflect new line count data and new call volume data to compare costs among states – the Commission does not update every loop and switching investment. The Commission does not account for every state-specific difference in the Commission's Synthesis Cost Model when applying its benchmarking analysis. Accordingly, our approach to measuring SWBT's relative costs declines from 1996 to 2001 is consistent with the Commission's approach to using the Synthesis Cost Model to measure relative cost differences.

16. In any event, it would be impossible for the Commission or any other party update the Synthesis Model to reflect all state specific changes in SWBT's Texas network. Indeed, only SBC has that information. And quite tellingly, SBC has conspicuously not offered its own analysis of the cost declines reflected by the Synthesis Cost Model that includes all of the information that it claims should be reflected in such an analysis. That omission strongly suggests that SBC's internal analysis confirms our findings – *i.e.*, that SWBT's Texas costs have declined dramatically since 1996.

17. In fact, our analysis is very conservative in that it likely vastly *understates* the Texas cost declines. For example, in the ongoing UNE rate proceeding in Texas, AT&T has

demonstrated that SBC's cost of capital has fallen dramatically compared to the cost of capital used to develop Pacific's current (and outdated) rates.²⁰ Accounting for this cost of capital reduction would have shown even greater cost declines in Texas. Likewise, our analysis of the SynMod did not account for other savings to SBC's overhead costs – as a result of mergers, layoffs and other changes in SBC's operations – that would show further cost declines since 1997. Thus, SBC's claim – with no supporting documentation – that accounting for additional factors would have reversed our conclusions is flatly wrong.

18. Pacific's other criticisms of our analysis also do not withstand scrutiny. Pacific claims that our analysis should be ignored because “the USF Cost Model [does] . . . not produce true forward-looking costs for SWBT Texas.”²¹ But that misses the point. As Pacific is well aware, our analysis does not attempt to measure the “true forward-looking costs” for SWBT Texas, but only attempts to measure *relative cost differences*. And the Commission has repeatedly determined that the Synthesis Cost Model is appropriate for that task.

19. Pacific also claims that the Synthesis Cost Model cannot be used to measure cost declines in Texas because it “does not reflect SWBT Texas company-specific TELRIC results.” That argument also must be rejected. Indeed, by Pacific's “logic,” the Commission also would have to reject the use of the Synthesis Cost Model for benchmarking purposes. If the Synthesis Cost Model is truly incapable of measuring relative Texas-specific costs, then the model could not be used either for measuring in-state Texas cost declines or for assessing relative cost differences between Texas and California. In reality, of course, the Synthesis Cost Model does

²⁰ See *Proceeding on Cost Issues Severed From P.U.C. Docket No. 24542*, Before the Public Utility Commission Of Texas, Docket No. 25834, Testimony of Terry L. Murray (filed November 4, 2002 (showing cost of capital reduction in Texas of approximately 315 basis points, from 10.36% to 7.24%).

²¹ Markarewicz Decl. ¶ 5.

use numerous state-specific inputs that are perfectly capable of measuring relative costs differences over time or between states.

B. Pacific's Criticisms of AT&T's ARMIS Data Analyses Are Baseless.

20. The fact that the Commission's Synthesis Cost Model shows that SWBT's Texas rates have declined substantially is, by itself, conclusive evidence that SWBT's Texas rates are no longer TELRIC-compliant. However, to further confirm that finding, AT&T also conducted an analysis of the cost declines reflected in the Texas cost data reported by SWBT to the Commission. As noted in our initial testimony, this analysis understates forward-looking cost declines because it shows only embedded costs changes, and does not reflect forward-looking cost differences, which would only widen the gap.

21. Pacific's principal criticism of our analysis is that declines in *embedded* costs are not appropriate for assessing whether *forward-looking* costs have declined. That argument does not withstand scrutiny. In fact, SWBT's Texas rates are based on numerous costs that rely on SWBT's embedded data. As one example, the purported "forward-looking" switching rates in Texas are based on the switching rates and switch discounts that the Texas Commission determined were available to SWBT between 1995 and 1997. To the extent that the switch prices (and hence forward looking switching costs) have declined since 1997, that trend likely will be reflected in SWBT's ARMIS data, which shows the switching costs reported by SWBT from 1996 through 2001. Thus, Pacific's claim that the ARMIS data is irrelevant to whether Pacific's forward-looking costs have declined since 1996 is baseless.

22. Pacific next complains that the ARMIS data relied on by my analysis – ARMIS 43-03 reports – reflects not only loop and switching cost declines, but also declines associated

with SWBT's Texas transport costs.²² Pacific claims that the better approach is to rely on data from the ARMIS 43-04 reports, which exclude interoffice costs. The reason why our initial analysis relied on SWBT's ARMIS 43-03 reports rather than the ARMIS 43-04 reports is that disaggregated cable and wireless depreciation data for specific plant accounts are not available at the loop and interoffice level in 43-04 reports. Because it is necessary to remove depreciation from gross investment figures to compute annual net investment, the direct availability of depreciation data in the 43-03 reports made computing net investments for those accounts much more straight-forward. In addition, the existence of transport in those reports had little impact on the cost *trend* because the relative amount of cable and wireless interoffice transport investment reflected in the 43-03 reports is small and relatively constant in the 1996-2000 time period.

23. In all events, Pacific's argument makes a distinction without a difference. As shown in Table 2 (below), recreating our initial analysis based on the data in the 43-04 reports (rather than 43-03 reports) does not change the conclusions of our initial analysis.²³ As shown in Table 1, SWBT's Texas ARMIS data show that Texas loop costs have fallen by at least 27.5%²⁴ and that Texas switching costs have fallen by at least 12%.²⁵

²² See Makarewicz ¶ 8.

²³ We estimated estimated depreciation for these accounts by applying the depreciation reserve derived from the 43-02 data for SWBT as used in our initial analysis.

²⁴ This estimate appears to be conservative, because SBC appears to underreport the number of switched access lines in its ARMIS 43-08 reports. Indeed, SBC reports a greater number of switched access lines in the Investor Relations ("IR") section of its website (See, e.g., <http://www.sbc.com/investor_relations/financial_and_growth_profile/statistical_profile/0,5931,39,00.html>). And the amount of underreporting appears to have grown over the years. See *id.* There also is a significant gap between SBC 43-08 total lines and the IR reported SBC Total Lines (Including VGEs) with the latter exceeding the ARMIS counts by over 30%.

²⁵ It appears that SBC's reported ARMIS data include DEMS only for SBC's retail residential and business lines. Those data do not appear to include DEMS associated with UNE-P and resale lines. Adjusting for that omission –

Net Investments per Unit of Demand

<u>Category</u>	<u>Net Investment per Unit</u>						<u>Total Change</u>
	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	
1) Net Cable & Wire Facilities per Line	\$310.25	\$298.66	\$276.30	\$244.77	\$265.67	\$224.82	-27.5%
2) Net Total Cable, Wire & Circuit per Line	\$430.55	\$433.03	\$417.06	\$382.06	\$432.47	\$377.73	-12.3%
3) Net Switching Equipment per DEM	\$0.0082	\$0.0073	\$0.0072	\$0.0066	\$0.0063	\$0.0072	-11.6%

24. Pacific provides its own analysis similar to that in Table 1. However, Pacific’s analysis contains critical flaws. As an initial matter, although Pacific’s version of Table 1 also is titled “Net Investment per Unit of Demand,” in reality, Pacific’s version of Table 1 reflects *gross investment* per unit of demand. In other words, Pacific’s analysis fails to subtract depreciation from the gross investment figures reported in SWBT’s 43-04 reports. This is a critical error. The purpose of this analysis is to determine SWBT’s cost of providing local telephone service. Those costs are based in part on the value of SWBT’s plant investment. The value of SWBT’s plant investment changes from year to year as SWBT makes new investments, and as SWBT’s older plant depreciates. Therefore, to accurately assess annual changes in SWBT’s costs, it is important to account for depreciation by removing depreciation from the investment figures. By failing to account depreciation, SWBT’s analysis severely understates the reduction in the cost of SWBT’s underlying plant, and hence the reduction in SWBT’s annual costs.

25. Another serious problem with the loop portion of the analysis shown in Pacific’s version of Table 1 is that it fails to reflect the correct number of lines and, therefore fails to reflect the substantial economies of scale associated with line growth in Texas. The number of

by increasing DEMS by the amount of Texas UNE-P and resale lines – shows that the actual reductions in embedded switching costs exceeds 20 percent.

lines served by SWBT in Texas grew by 49% between 1996 and 2001.²⁶ In many instances that line growth reflects multiple lines carried over a single high-capacity line, and it is important to reflect that fact when computing the number of lines used for computing cost trends. Indeed, the Commission has expressly endorsed the use of voice-grade equivalent lines, as opposed to a physical line, approach to represent high-capacity lines.²⁷

26. Pacific's analysis however fails to reflect the full amount of line growth in Texas because it generally counts high-capacity lines as a single line.²⁸ By underestimating line growth in this way, Pacific's analysis of SWBT's costs fails to reflect the large efficiency gains associated with serving all of the voice grade equivalent lines in Pacific's network. That is Pacific fails to allocate the total net loop costs in each year over the *actual* number of voice-grade lines served by SWBT in Texas.²⁹

IV. PACIFIC'S CLAIMS THAT CALIFORNIA AND TEXAS HAVE SIMILAR RATE STRUCTURES AND GEOGRAPHIC CHARACTERISTICS ARE SPECIOUS.

27. As explained in our initial testimony, there are substantial differences between the rate structures of California and Texas that preclude the use of Texas rates as a benchmark against California rates. As one example, we demonstrated that to compare the average non-loop charge in California and Texas it is necessary to know the average vertical feature charge –

²⁶ See Lieberman/Pitkin Decl., Table 1.

²⁷ *Tenth Report and Order* ¶¶ 99-100 (supporting the use of voice-grade equivalence for high-capacity lines, and developed inputs for its Synthesis Model accordingly).

²⁸ See Makarewicz Decl. ¶¶ 9-10.

²⁹ As noted, the total lines reported by SBC in its ARMIS reports is lower than that SBC reports to the investment community (See n.26, *supra*). Using the higher line counts that SBC reports to the investment community would show further cost declines since 1996. Because the data SBC reports to the investment community for total lines is not reported at the state level, I have not attempted to account for those higher line counts in my analyses. As a matter of course, we know that the ARMIS 43-08 Total Lines, which we are using, do not reflect non-switched lines reflective of SBC's retail channel tariffs (local or intrastate), and only reflects those that are derivative of the "Special Access" tariff. In 1996, the disparities due to non-switched retail lines and wholesale lines is much smaller than in 2001, because the investment data reflects all lines. Thus, the larger disconnect between 2001 line and investment results in a dramatic understatement of net investment per line unit cost decline.

which is a component of the non-loop category. But the rate structures in California and Texas recover vertical features cost in entirely different ways. Whereas Pacific recovers the cost of vertical features through 31 different rate elements, SWBT recovers the costs of vertical feature costs through the traditional switch related rate elements. That means that it is necessary to convert the 31 California vertical features charges into an average rate that is actually paid by Pacific's customers, which requires estimation of penetration rates for the 31 vertical features in California.

28. Pacific does not even attempt to resolve this serious obstacle to comparing rates. Instead, Pacific asserts that it is fair to simply assume that the average California customer will purchase three vertical features. Pacific, however, offers no analysis or other justification for its choice of three vertical features, except for noting that AT&T used three vertical features in the residential margin analyses that was submitted in the California UNE rate proceeding. The problem with relying on the number of vertical features used in that margin analysis is the analysis was a *residential-only* analysis that did not account for vertical features for business customers, which have very different feature use patterns. It is not appropriate to rely on the number of vertical features in that margin analysis – as Pacific does – to conduct a benchmark analysis, which must reflect the vertical features ordered by both residential and business customers. Indeed, there are a number of vertical features that are almost exclusively purchased by business customers. For example, Pacific offers a feature called “*hunting*,” which is a service that defines a series of lines to which an incoming call will be routed. This feature is used almost exclusively by multi-line businesses that would, for example, want incoming calls routed first to customer service lines, and if those lines are unavailable to alternative lines. Another feature offered by Pacific that is used almost exclusively by business customers is a feature called

“Directed Call Pick-Up,” which allows one employee to access another employee’s line by dialing a code into a telephone located in another office or in a common area. Moreover, even for features that both residential customers and business customers purchase, there is no evidence that residential customers and business customers purchase the same number of those features. There is no question therefore that residential vertical feature penetration is not necessarily representative of business penetration. Thus, Pacific’s reliance on a residential-only vertical features penetration estimate for conducting a benchmarking analysis clearly is inappropriate.

29. We also identified other important rate structure differences that Pacific has not adequately addressed. For example, California’s switching rates utilize a “set-up and duration” cost structure which requires accurate assumptions about the duration of the average call in California in order to develop rates that can be benchmarked to Texas. Moreover, California usage rates have three pairs of set-up and duration rates: a pair for interoffice originating, interoffice terminating and intraoffice. Thus, in addition to determining three holding times, it is also necessary to know the percent of traffic that is intraoffice in order to perform a switch cost comparison to determine the per minute equivalent of the three set-up rates.

30. The Texas rate structure also is unique compared to all other states in that the port rate and switch usage rates are based on rate-groupings that depend on the number of lines served by particular central office machines.³⁰ Moreover, these four port/switching rate groups do not correspond to the three UNE zones used for other elements, requiring that these port/switching rates be mapped to the three UNE zones at the wire center level. Thus, any benchmarking comparison between California and Texas therefore would have to accurately

³⁰ See Lieberman/Pitkin Decl. ¶ 19.

measure the port rate in Texas in such a way that it is comparable to the port rate in California.³¹

31. Pacific's sole response to this problem is that "it is a straightforward calculation to weight the rate groupings in order to arrive at a rate per loop."³² Tellingly, however, Pacific does not identify that "straightforward calculation." Indeed, such a calculation would be extremely difficult to accurately compute without substantial wire-center specific data that SBC has not made available to third parties or to the Commission.

V. PACIFIC'S CLAIM THAT CALIFORNIA AND TEXAS ARE GEOGRAPHICALLY SIMILAR DOES NOT WITHSTAND SCRUTINY.

32. As we demonstrated in our initial testimony, Pacific's claim that Texas is an appropriate benchmark because California and Texas "share certain demographic and geographic features"³³ does not withstand scrutiny. That claim is based on geographic factors – *e.g.*, population, number of households, persons per household, land area, number of urban places, and the number of central offices – that have little relevance to the costs of a local telephone network. The relevant geographic statistics for determining whether two states are sufficiently similar that they can be benchmarked against one-another relate to the geographic dispersion of *telecommunications* equipment and customers. And as AT&T demonstrated these statistics are very different in Texas than they are in California.

33. On Reply, Pacific effectively concedes this point, noting that the relevant geographic information are the "density metrics cited in Table 1 of [Mr. Makarewicz's] . . .

³¹ The difficulty in assessing the Texas port rate is underscored by the fact that the average port rate in Texas (according to various representations made by SBC) has ranged from \$2.22 to \$2.90 during SBC's various 271 proceedings.

³² Makarewicz Decl. ¶ 20.

³³ Makarewicz Decl. ¶ 9.

Affidavit.”³⁴ The population densities in that Table show that in California the average urban population density is 7,857, whereas the average population density in Texas is only 3,319. Because there are fewer customers, located across larger areas in Texas than California, the costs and methodology of deploying a telephone system in Texas are substantially different from those in California.³⁵

VI. CONCLUSION

34. Recent findings by the Texas state commission, analysis of Texas costs, and analysis of Texas’ and California’s rate design and geographic characteristics all confirm that Texas rates are not a valid benchmark for assessing Pacific’s California rates.

³⁴ Makarewicz Decl. ¶ 22.

³⁵ Although AT&T is not advancing a price squeeze claim in this proceeding, we noted in our initial declaration that the price squeeze testimony advanced by Pacific’s witness contained numerous flaws. Pacific has not directly addressed those flaws. Instead, Pacific has, for the most part, acknowledged that we criticized its analyses and then simply repeated its initial arguments. We stand by our initial criticisms of Pacific’s price squeeze analyses.

VERIFICATION PAGE

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

/s/ Michael R. Lieberman

Michael R. Lieberman

Executed on: November 26, 2002

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

/s/ Brian Pitkin

Brian Pitkin

Executed on: November 26, 2002

*AT&T Ex Parte, Lieberman/Pitkin Supp. Decl.
Pacific 271 Application, WC Docket No. 02-306*

ATTACHMENT A

Investor Update

October 24, 2002



2002 Q3 Earnings

Agenda

3Q Overview

Ed Whitacre

3Q Results

Randall Stephenson

Qs and As



Cautionary Language Concerning Forward-Looking Statements

Information set forth in this presentation contains financial estimates and other forward-looking statements that are subject to risks and uncertainties. A discussion of factors that may affect future results is contained in SBC's filings with the Securities and Exchange Commission. SBC disclaims any obligation to update and revise statements contained in this presentation based on new information or otherwise.



third-quarter **overview**

Ed Whitacre



2002 Q 3 Earnings

third-quarter results

Randall Stephenson



2002 Q 3 Earnings

Reported Results

(in millions except per-share amounts)

Revenues	\$ 10,556
Cash Operating Expenses	\$ 6,287
Total Operating Expenses	\$ 8,435
Net Income	\$ 1,770
Earnings Per Diluted Share	\$ 0.53



Normalizing Factors

(in millions except per-share amounts)

Revenues

Reported **\$10,556**

60% of Cingular's
revenues 2,225

Normalized **\$12,781**

Earnings

Reported **\$1,770** **EPS**
\$0.53

Force reductions 125 0.04

International gains
and charges (212) (0.06)

Normalized **\$1,683** **\$0.51**



Normalized Results

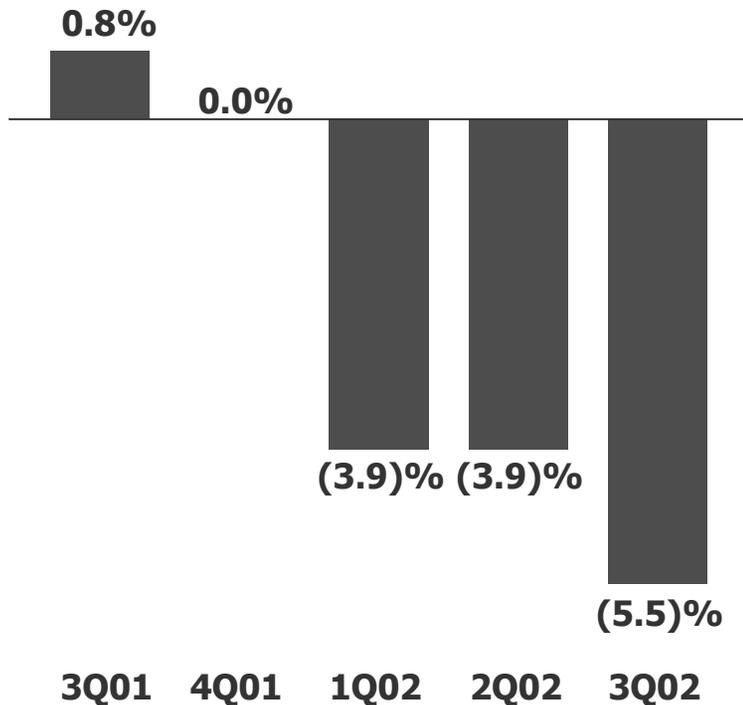
(in millions except per-share amounts)

		Change from 3Q01
Revenues	\$ 12,781	(5.5) %
Cash Operating Expenses	\$ 7,651	(3.0) %
EBITDA Margin	40.1%	(160)bp
Net Income	\$ 1,683	(15.8) %
Earnings Per Diluted Share	\$ 0.51	(13.6) %

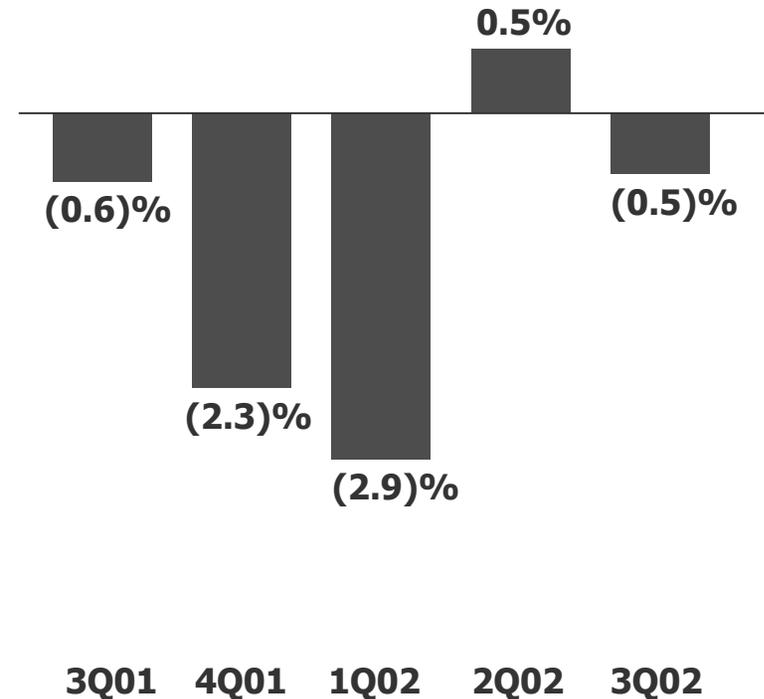


Revenue Trends

Consolidated Revenues YOY Growth

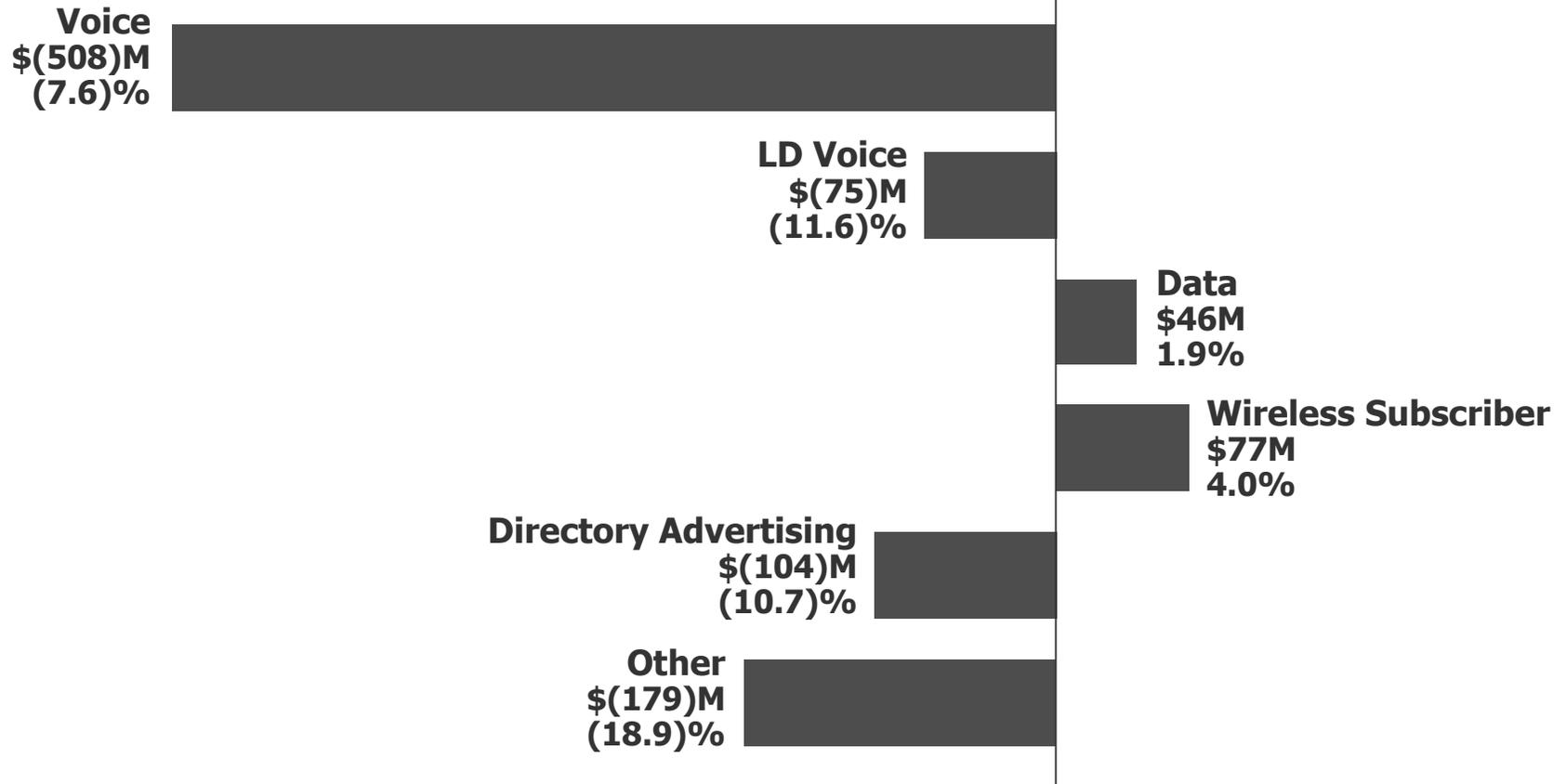


Consolidated Revenues Excluding Directory Sequential Growth



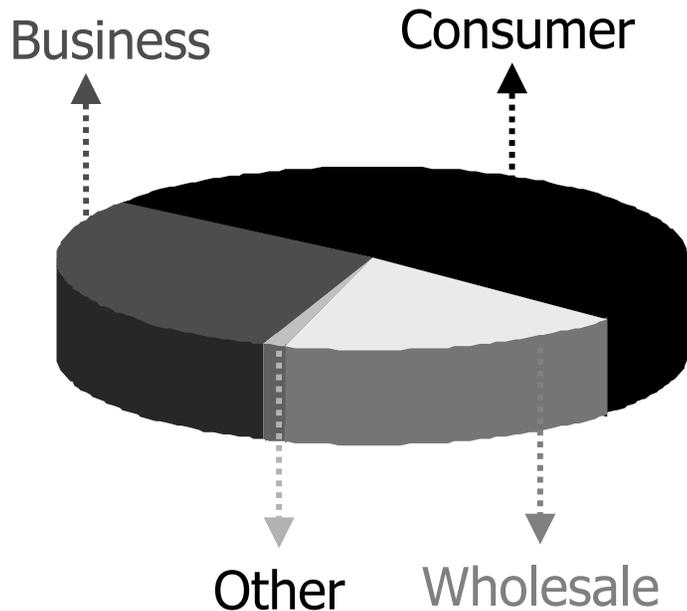
Revenue by Product Category

YOY Difference - 3Q02/3Q01



Voice Revenue Growth by Customer Segment

Segment Revenue Mix 3Q02



YOY Growth Rates

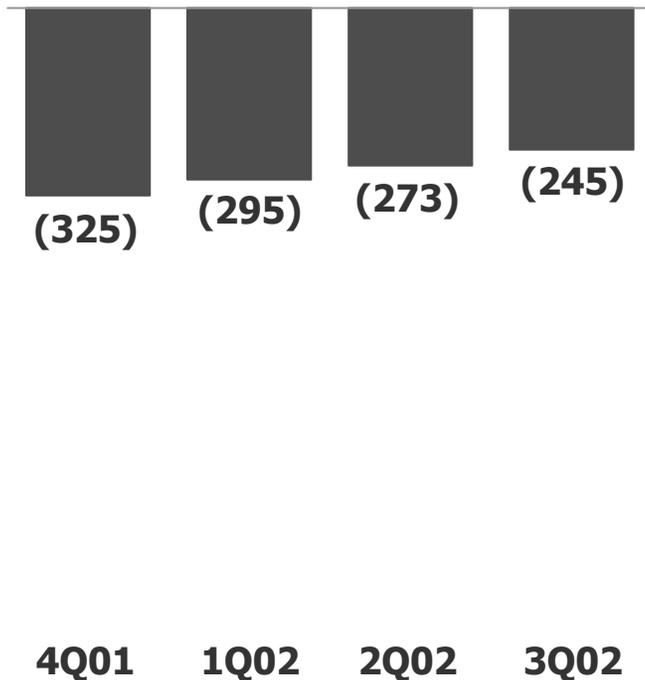
	3Q02	2Q02
Consumer	(8.3)%	(4.4)%
Business	(8.0)%	(13.7)%
Wholesale	2.0 %	(4.6)%

Consumer	(8.3)%	(4.4)%
Business	(8.0)%	(13.7)%
Wholesale	2.0 %	(4.6)%

Retail Access Line Trends

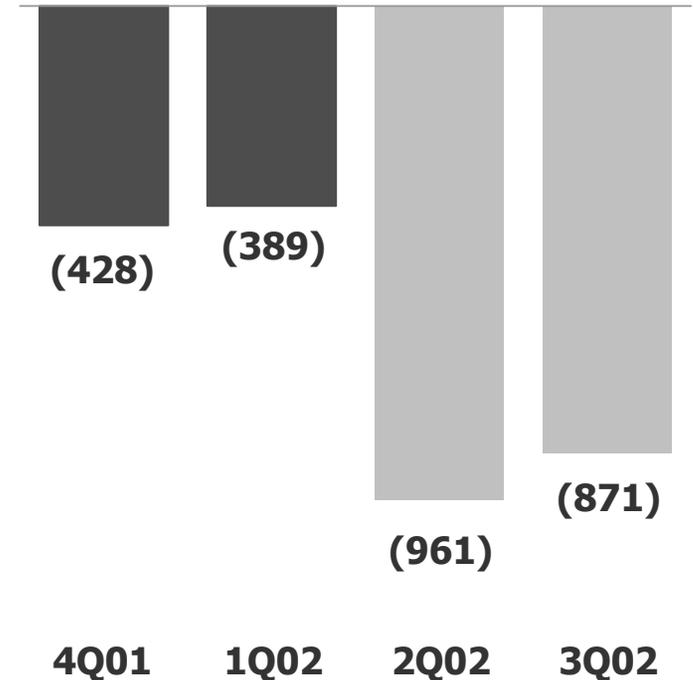
Business Non-ISDN Quarterly Change

(in thousands)



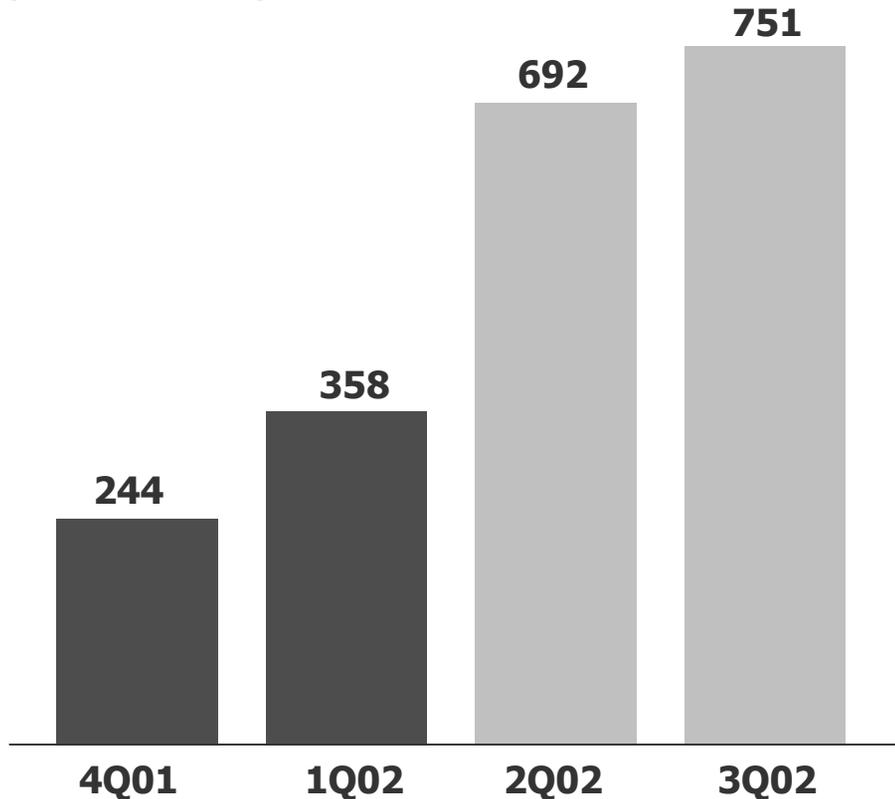
Consumer Quarterly Change

(in thousands)



UNE-P Trends

Quarterly Change in UNE-P Lines (in thousands)

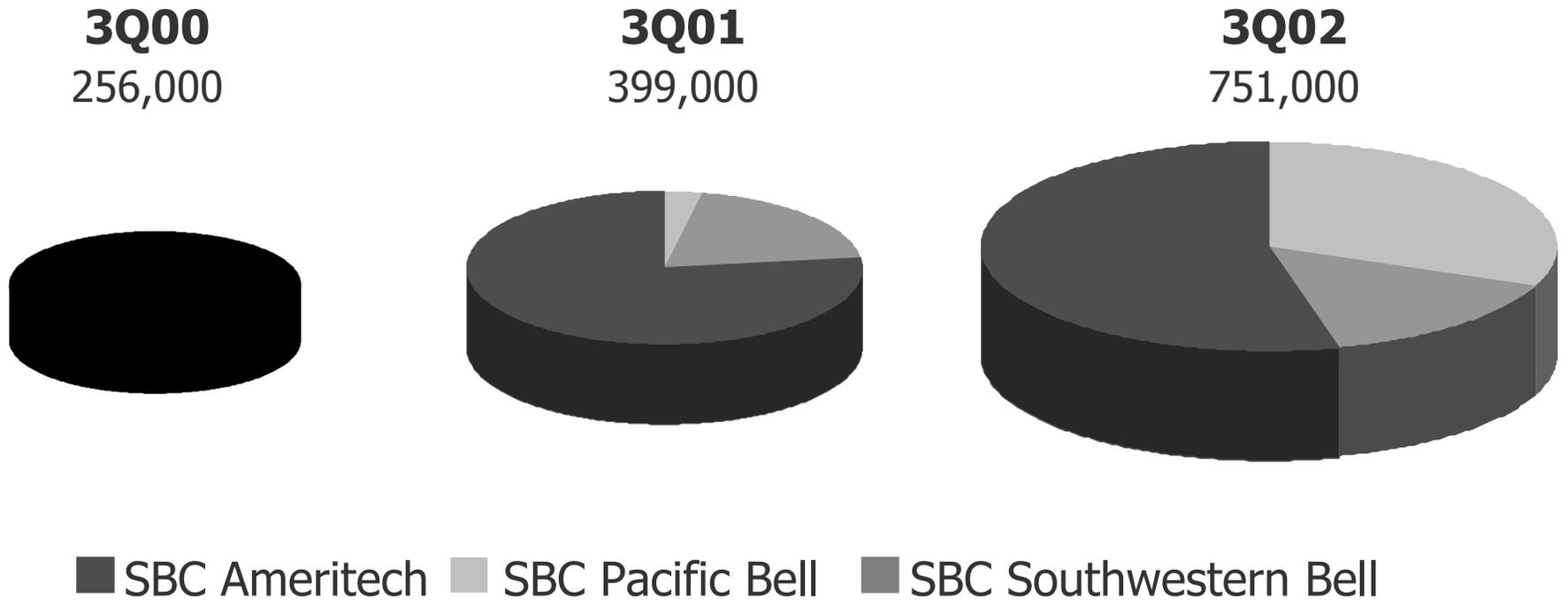


- Nearly 90% of 3Q net UNE-P change was consumer
- 82% of the 3Q UNE-P line change came from 5 lowest-priced states
- SBC currently operates without LD freedom in all of these states



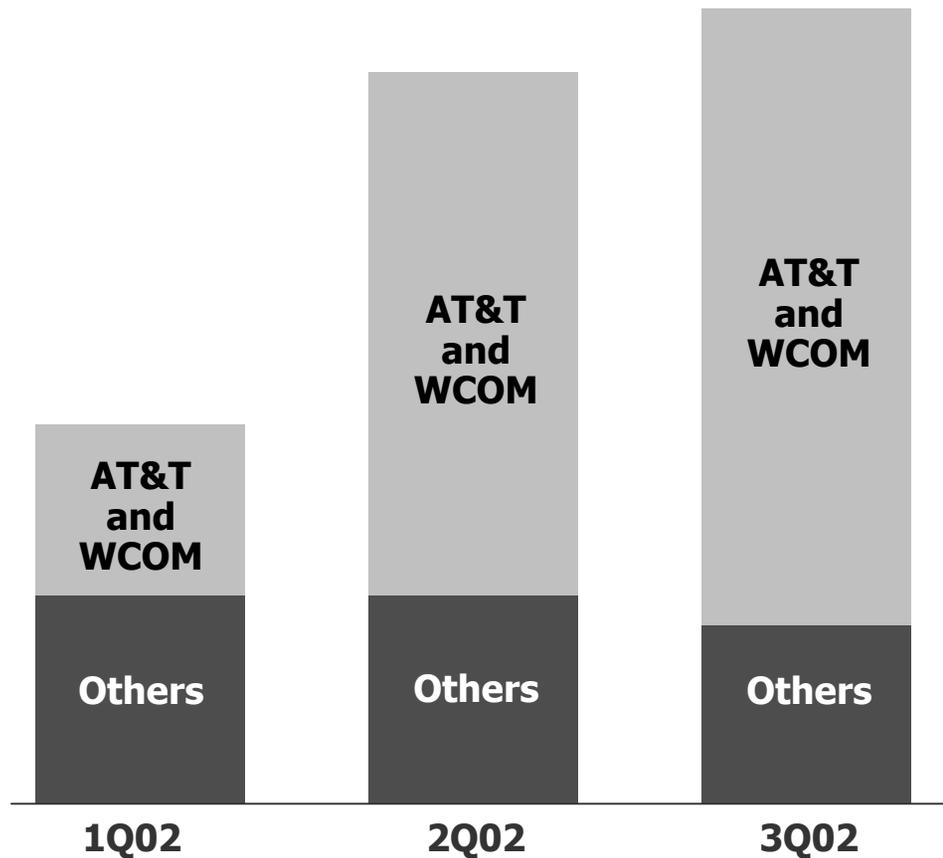
UNE-P by Region

Quarterly Change in UNE-P Lines



Users of UNE-P

Quarterly Change in UNE-P Lines



- More than 75% of SBC's UNE-P lines added in 3Q02 were for the two largest IXCs
- From 1Q02 to 3Q02, UNE-P lines added for AT&T and WorldCom/MCI more than tripled while UNE-Ps added by others actually declined



SBC Initiatives

- **Regulatory**

- Meetings with FCC and key state regulators
- Cost studies

- **Costs**

- Additional 11,000 force reduction
- Cuts proportionately greater in states with lowest UNE-P
- Lowering cap ex to about \$5 billion in 2003

- **LD Entry**

- California
- Ameritech states

- **Marketing Initiatives**

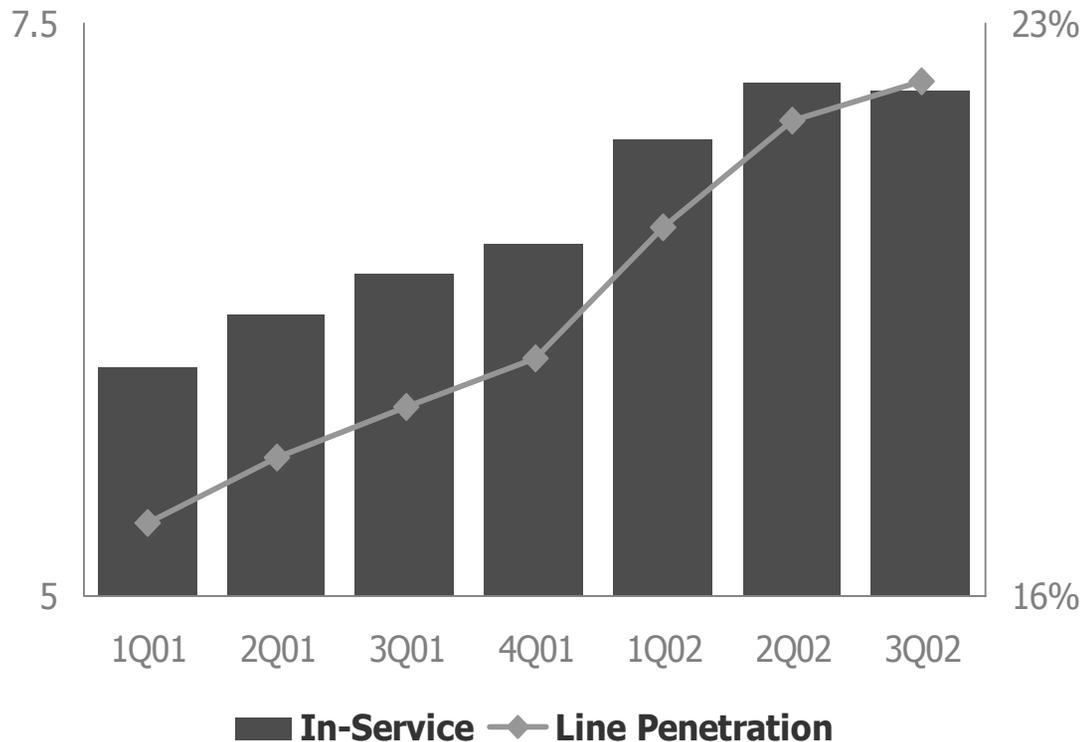
- Aggressive product bundling
- Expanded winback, retention efforts



Growth in Consumer Bundles

Consumer Bundles In-Service

(in millions)



- >7 million consumer bundles in service ... up 13% over past year
- 400 bp increase in line penetration versus 3Q01
- Newer bundles provide greater product choices

Extensive Product Bundling

Products Available for Bundling

	SBC Southwestern Bell	SBC Pacific Bell	SBC Ameritech
Local Voice	✓	✓	✓
InterLATA LD	✓		
Broadband	✓	✓	✓
Wireless	✓	✓	✓
Video	✓	✓	✓

- Savings grow with more services in bundle
- Responding to customer requirements
 - Flexibility and choice
 - Savings
 - One bill
 - One stop
- Video available through EchoStar*

* Billed separately by EchoStar



Texas Consumer Offer

Texas Consumer Bundle – \$95

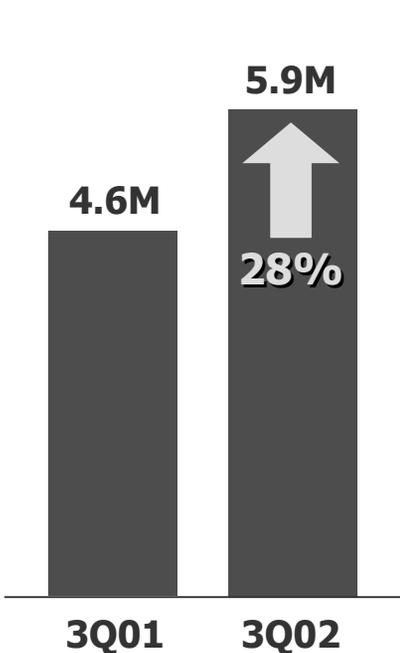
Cingular Wireless	<ul style="list-style-type: none">• 250 peak minutes• 1,000 nights and weekends
DSL	<ul style="list-style-type: none">• \$29.95 for 12 months• \$39.95 after 12 months
LD	<ul style="list-style-type: none">• 200 minute block of time• \$0.08 per minute after allotment
Vertical Features	<ul style="list-style-type: none">• Caller ID and Call Waiting• Privacy Manager
Local Voice	<ul style="list-style-type: none">• Access line• Unlimited local usage

- Total bundle price of \$95 per month
- Optional EchoStar service for \$27.95 per month with local programming
- Customers have flexibility to add features or expand calling plans

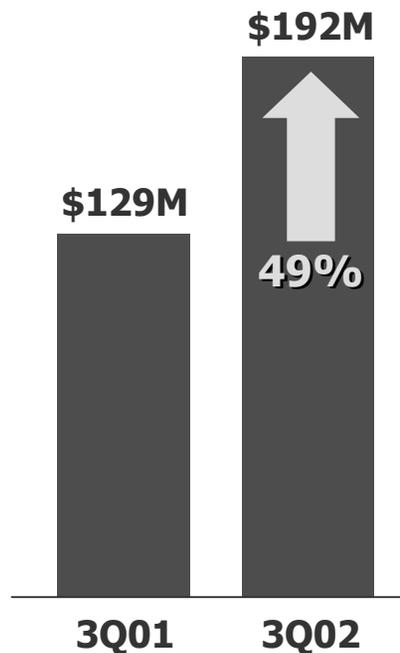


Long-Distance Growth

InterLATA LD Lines



InterLATA+Intl. LD Revenues

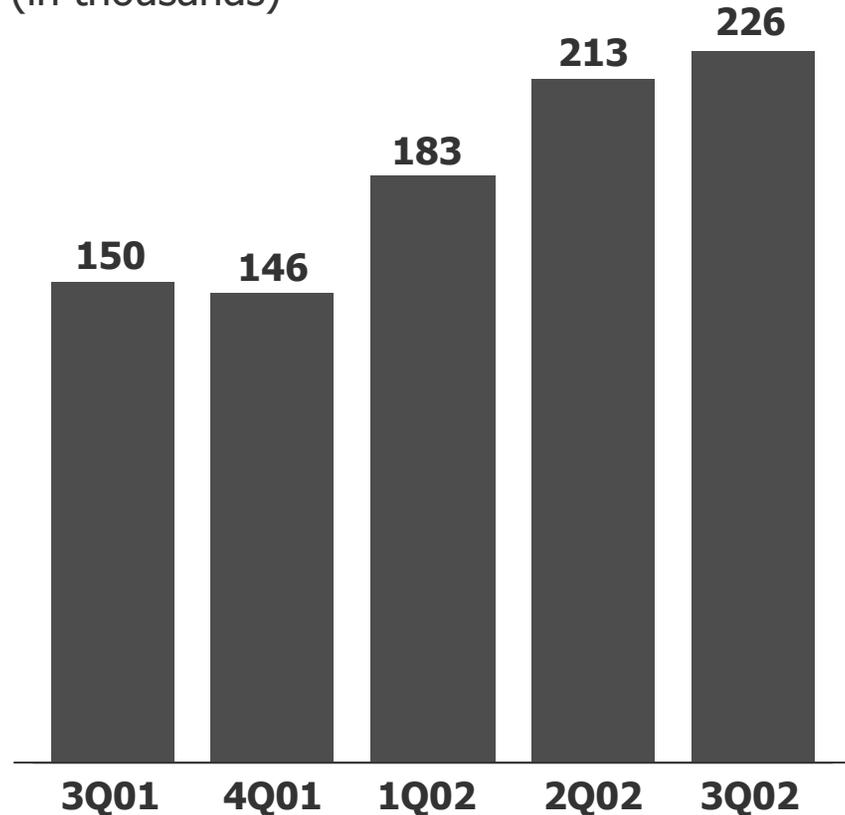


- Plan to enter California LD market by the end of this year
- Project state approval for the five Ameritech states in the first half of 2003

Strong DSL Growth

DSL Net Adds

(in thousands)

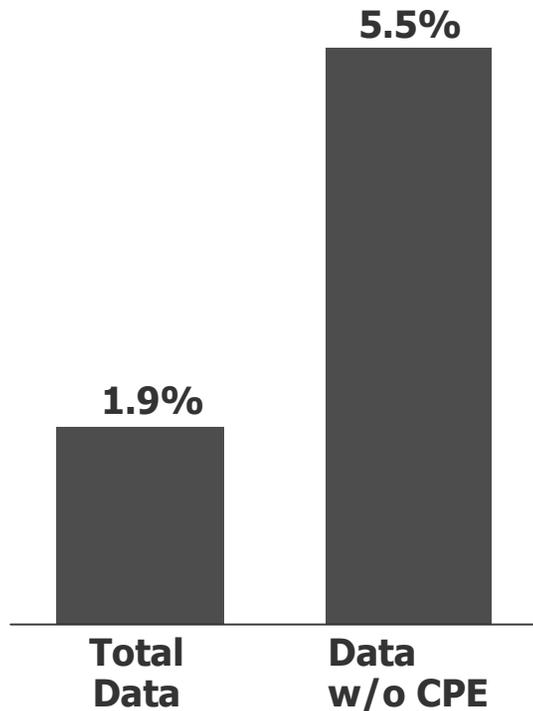


- 2 million subscriber milestone reached in October
- >50% growth in net adds versus 3Q01
- 3 consecutive quarters with sequential growth in net adds
- Robust value proposition
 - SBC Yahoo! Portal
 - Speed Tiers



Data Growth

Data Revenue Growth 3Q02 YOY



Data Transport Revenue Growth Rates

	YOY
SBC	3.3%
Consumer	47.0%
Business	(1.4)%
Wholesale	3.3%



Cingular Growth

Subscribers



Subscriber ARPU (monthly)



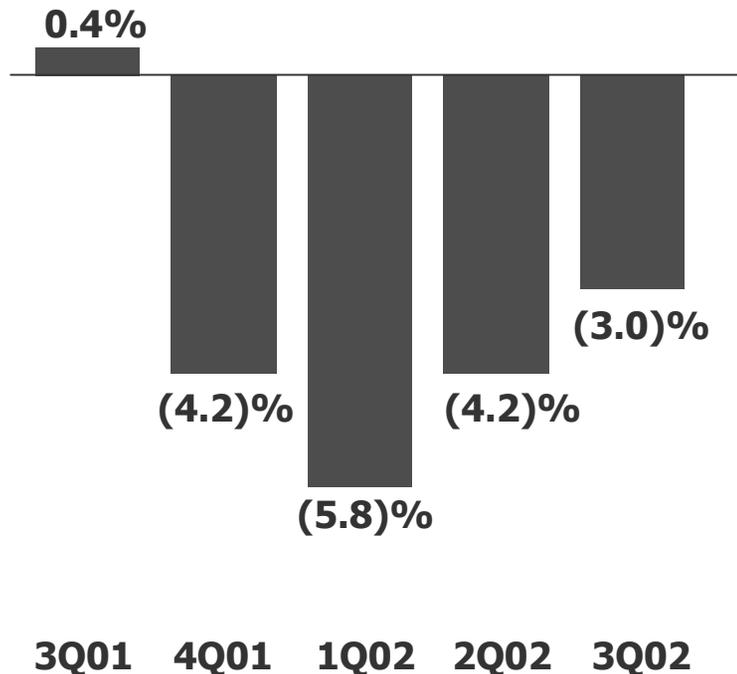
- 253,000 digital contract net adds in 3Q02
- 5th consecutive quarter with year-over-year increase in subscriber ARPU



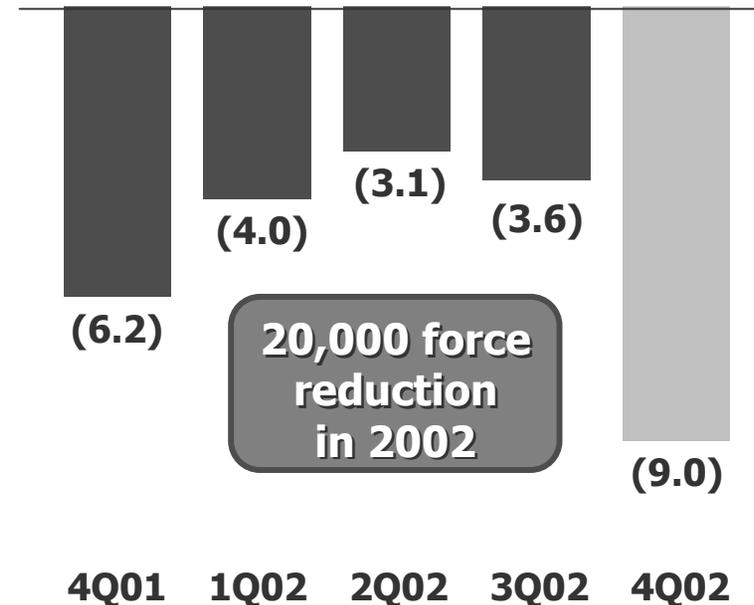
Operating Expenses

(normalized)

YOY Cash Operating Expense Growth

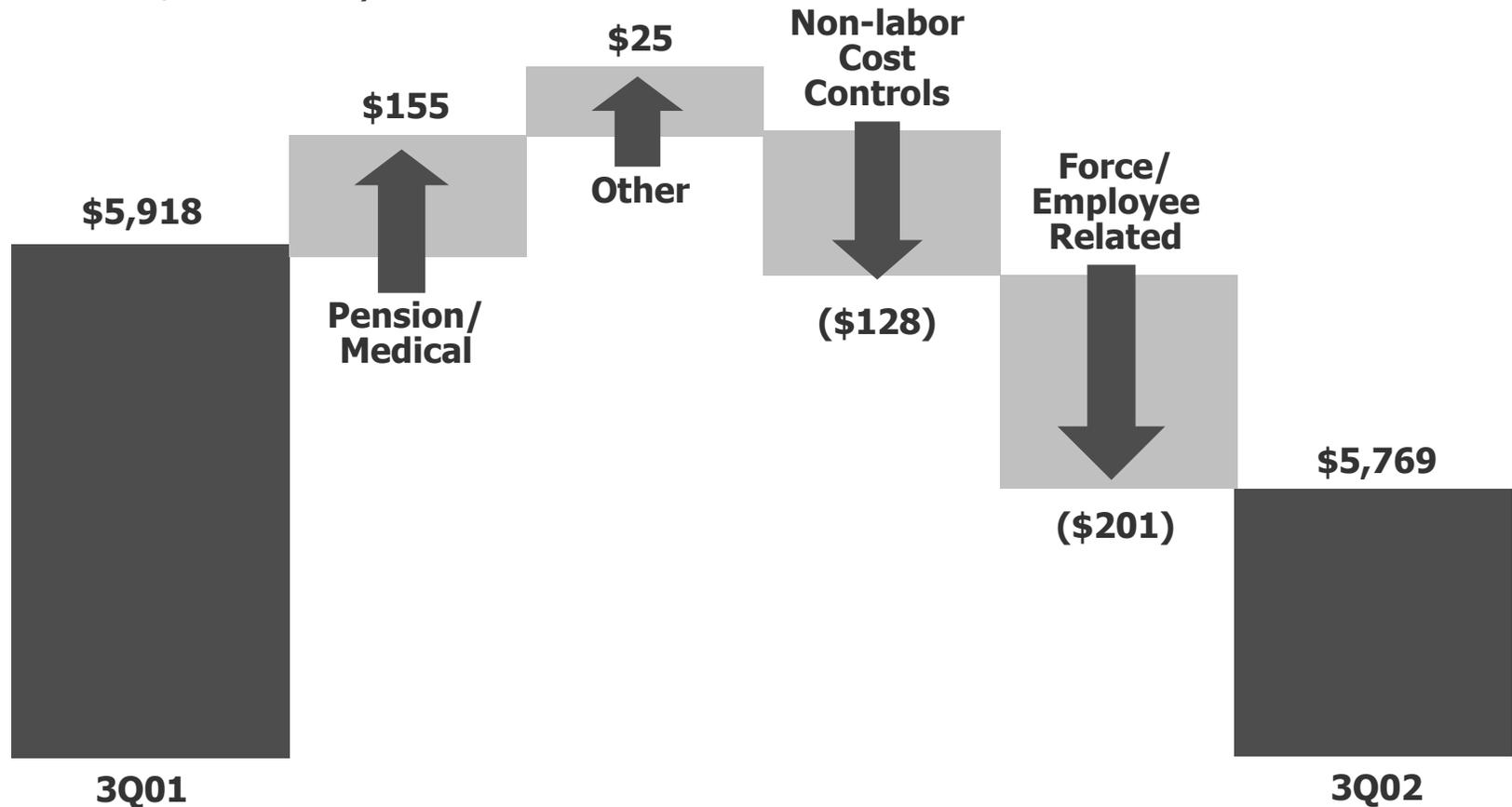


Force Reductions (in thousands)



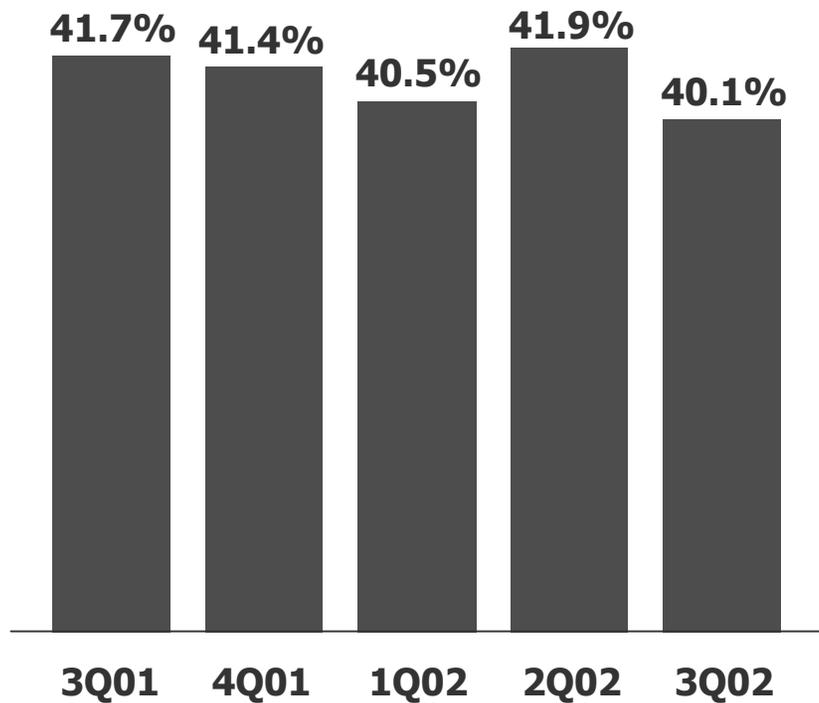
Wireline Expenses

(normalized, in millions)

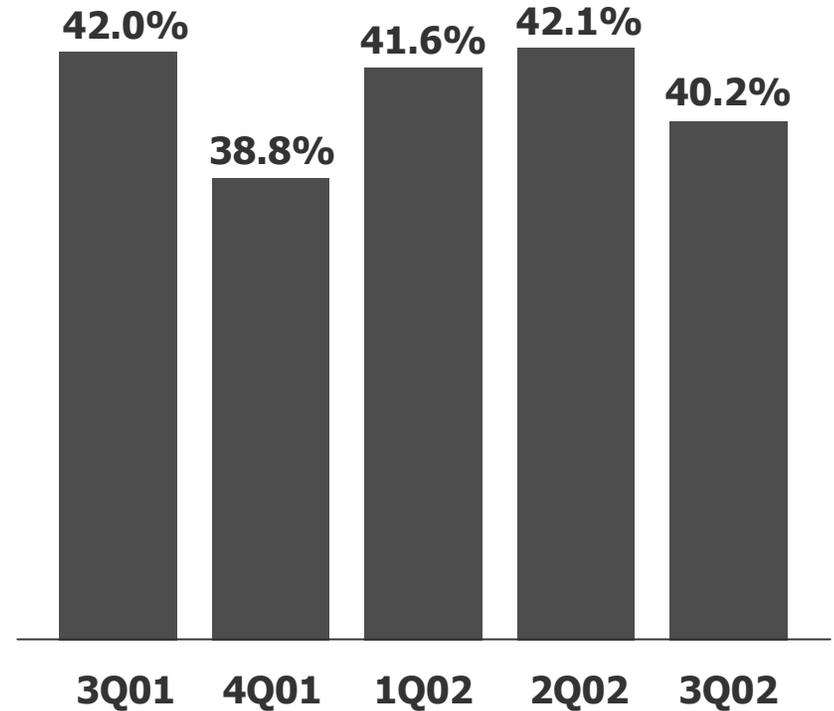


EBITDA Margins

SBC EBITDA Margins



Wireline EBITDA Margins

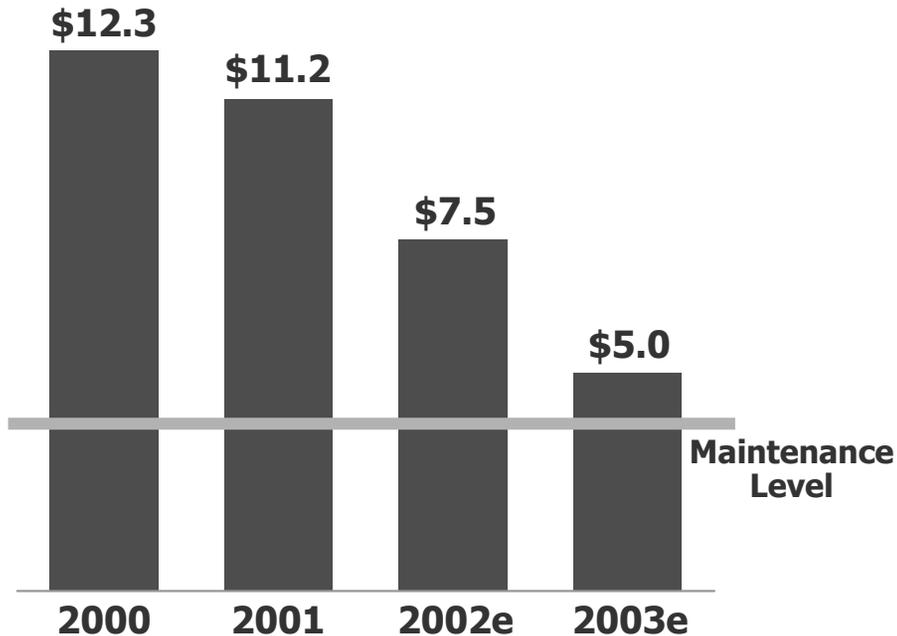


Disciplined Cap Ex

(excludes wireless)

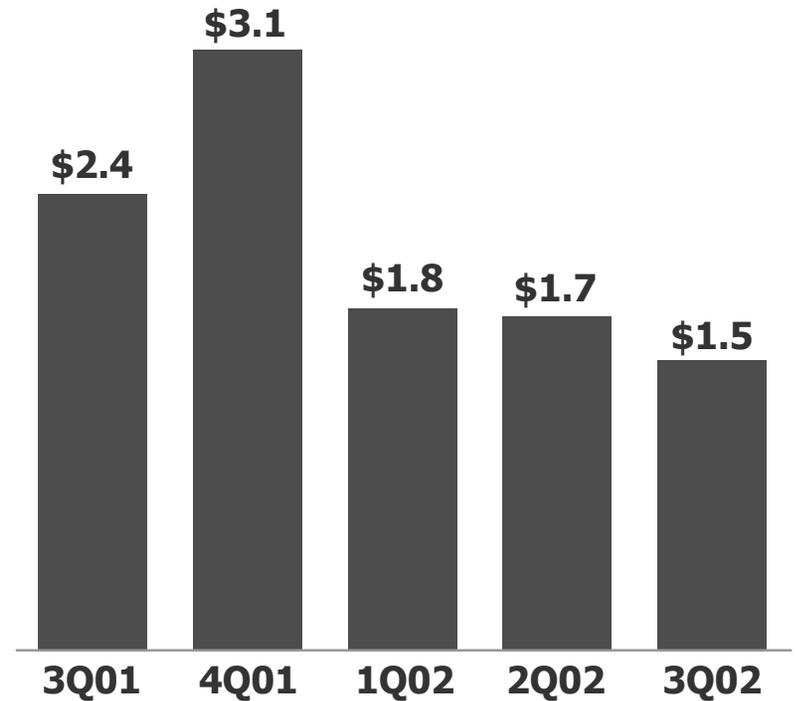
Annual Capital Spend

(in billions)



Capital Spend By Quarter

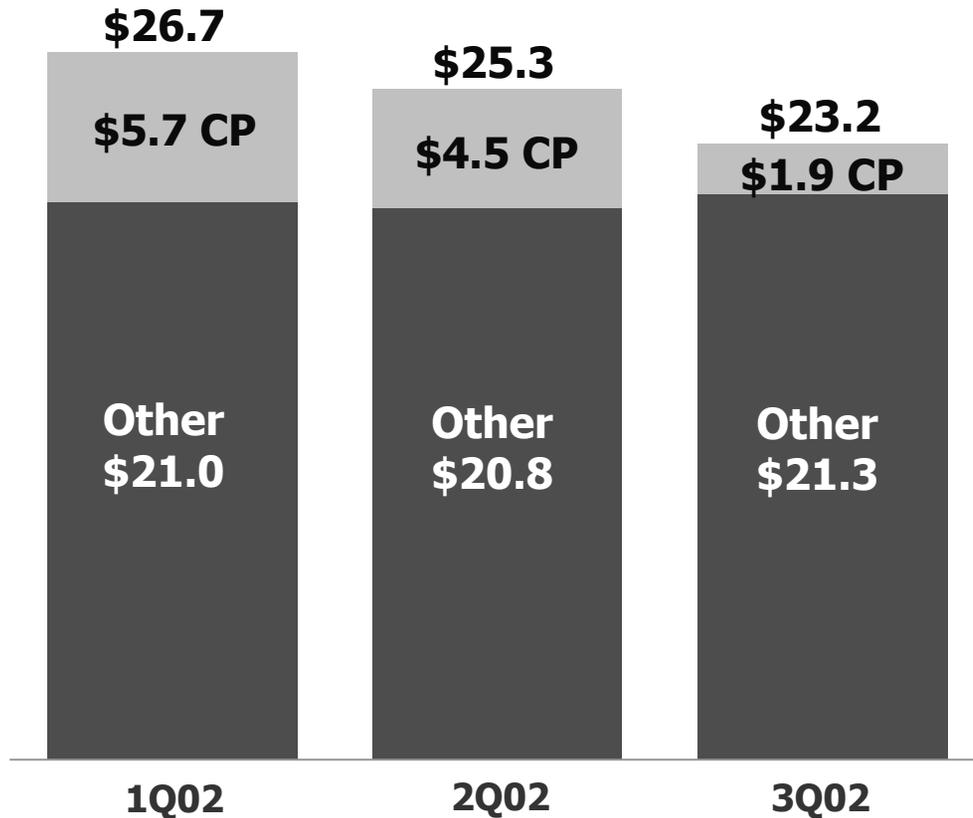
(in billions)



Strong Balance Sheet

Debt Balances Net of Cash*

(in billions)



Over last six months:

- \$3.5 billion total debt reduction net of cash
- \$3.8 billion cut in commercial paper net of cash ... \$2.6 billion cut in 3Q02

* Commercial paper shown net of cash



Clear Focus

- Cost discipline
 - Sustained productivity improvements
 - Cap ex
- Long-distance expansion
- Marketing/bundling initiatives
- Full-year EPS target of \$2.26, before one-time items



EXHIBIT 2
MURRAY SUPP. DECL.

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

In the Matter of)	
)	
Application of SBC Communications Inc.,)	
Pacific Bell Telephone Company, and)	CC Docket No. 02-306
Southwestern Bell Communications Services,)	
Inc. for Provision of In-Region, InterLATA)	
Services in California)	
)	

**SUPPLEMENTAL DECLARATION OF
TERRY L. MURRAY**

1. My name is Terry L. Murray. I am the same Terry L. Murray who filed a declaration with AT&T's initial comments in this proceeding. In that declaration, I demonstrated that Pacific's California unbundled network element ("UNE") rates are inflated by clear Total Element Long Run Incremental Cost ("TELRIC") errors. In particular, I showed that Pacific's NRCs are inflated by at least 25% because they improperly reflect recurring costs and that Pacific's switching rates are inflated by non-TELRIC vertical features charges. The purpose of my supplemental declaration is to respond to the baseless attacks on my testimony by Pacific witness Richard L. Scholl.

- I. PACIFIC'S NRCs ARE INFLATED BY AT LEAST 25 PERCENT BECAUSE THOSE NRCs UNLAWFULLY REFLECT RECURRING RATES.**

2. As I explained in my initial testimony, the CPUC noted in December of 1998 that Pacific Bell's NRCs include "[s]o called 'loaded' recurring costs represent[ing] approximately

25% of the total costs for NRCs.”¹ After CLECs pointed out that recovery of these recurring costs through NRCs is unlawful, the CPUC explained that it is “well aware of the FCC’s August 8, 1996 First Report & Order that prohibited the ILECs from recovering recurring costs in NRCs, but that requirement has been stayed by the Eighth Circuit. Should the Supreme Court reverse the Eighth Circuit’s stay on pricing provisions of the First Report & Order, we will direct Pacific . . . to remove [the recurring costs] . . . from their nonrecurring cost studies.”² The Supreme Court has now reversed the Eighth Circuit’s stay of the pricing provisions of the in *First Report & Order* and has also affirmed the validity of the TELRIC methodology. However, the CPUC has not required Pacific to remove the recurring costs from its NRCs. Thus, it is clear that Pacific’s NRCs are as much as 25% above properly calculated TELRIC-based prices.

3. Pacific responds to this problem with two distinct, yet equally meritless, arguments. First, Pacific claims that recovery of these recurring costs through NRCs does not result in double-counting of recurring costs.³ That argument misses the point. The problem that the CPUC acknowledged concerning Pacific’s recovery of recurring costs through NRCs is not that it results in double counting (although it may well do so), but that recovery of recurring costs through NRCs violates TELRIC principles and deters UNE-based entry into local telephone markets.

¹ CPUC Decision 98-12-079, at 51 (December 17, 1998). Loaded recurring costs are costs associated with items such as “such as office furniture, equipment and motor vehicles,” which the CPUC acknowledged are recurring in nature. *Id.* at 52.

² *Id.* at 53.

³ See Scholl Decl. ¶ 5.

4. The Commission's TELRIC rules expressly forbid the shifting of recurring costs to non-recurring charges, 47 C.F.R. 51.507(d) ("recurring costs shall be recovered through recurring charges"). The reason why the Commission's rules prohibit such behavior is that inflating NRCs with recurring costs creates a substantial barrier to competitive entry. Overstating NRCs (which are paid up-front by carriers) with recurring rates means that new entrants face increased risk, because the amount of certain loss – *i.e.*, the NRCs – increases if the carrier's entry plans are unsuccessful. That is, if a new entrant must pay all of these costs to the ILEC up front, then the carrier will lose all of that sunk investment if its entry plans prove unsuccessful. By contrast, if recurring costs are recovered over time as they are incurred, potential entrants will face only the risk of losing the portion of those costs that have already been paid. In this way, inflating NRCs with recurring costs increases the risk of entry, thereby deterring local entry.
5. Pacific does not dispute this, but argues that the costs in questions are not, in fact, recurring costs, but are non-recurring costs.⁴ As an initial matter, Pacific's argument contradicts the express findings of CPUC, after full litigation, that the costs in question are in fact recurring costs. Indeed, that is precisely why the CPUC promised to disallow recovery of these costs through NRCs if the Supreme Court upheld the Commission's TELRIC rules (which the Supreme Court has now done).
6. Pacific now asks this Commission to reverse the CPUC's findings that these costs are recurring costs, and not NRCs. Pacific's new arguments here – which were not presented

⁴ See Scholl Decl. ¶ 14.

to the CPUC – in support of this position, however, are entirely without merit, and should be rejected.

7. According to Pacific, this Commission should reverse the CPUC’s finding that the costs in question are NRCs, because, according to Pacific, “[t]he costs at issue are the costs of the one-time event of using a capitalized item (*e.g.*, a truck) while installing a UNE, not costs of ongoing events.”⁵ That argument is baseless.
8. The fact that costs for a particular piece of equipment are capitalized, and are used only to install a UNE does not mean that the capitalized costs of that equipment are properly allocated to NRCs. Indeed, the vast majority of capitalized costs for equipment that is used only prior to installation or at the time of installation – *e.g.*, telephone poles, switches, motor vehicles – are properly recovered through recurring rates. These recurring charges convert the capital cost into a series of rental payments that recover depreciation, taxes and return on investment, which are added to the recovery of recurring operations and maintenance costs.
9. It is therefore not surprising that the example provided by Mr. Scholl (¶ 17) in an attempt to justify recovering the cost of trucks when used for service installations as an up-front cost is badly flawed. Here, it is important to note that the costs of motor vehicles should be (and generally are) recovered as a recurring charge that reflects their depreciation over time. And that is how Pacific’s cost study recovers most of the costs of motor vehicles and other secondary investments, *i.e.*, the depreciation of those vehicles and other support

⁵ Scholl Reply Decl. ¶ 14.

investments is annualized and then recovered through recurring charges.⁶ However, Mr. Scholl contends that the costs of trucks when used to install services, unlike the cost of the *exact same trucks* when used for other purposes (*e.g.*, to perform operations and maintenance tasks), should be recovered as an NRC. His reasoning is that, when trucks are used to install UNE loops, the costs of their use in this activity are incurred only once, at the time of installation. That argument misses the point entirely. The costs of trucks used to install UNE loops, like the costs of all motor vehicles owned by Pacific, are related to depreciation, and that depreciation occurs continuously over time. Accordingly, depreciation is properly recovered by spreading out those costs over time and recovering them through recurring cost elements, not through an up-front lump sum.

10. The same logic applies to the other secondary investment costs that Mr. Scholl identifies as having been loaded into Pacific's NRCs. Like the trucks used to install UNEs, office furniture and computers are all used before, during and after UNE installations for a variety of functions. The costs of these capital items are all properly recovered through depreciation charges spread over the useful life of the investments and not through NRCs. On this record, there is no basis for the Commission to find that, notwithstanding that Pacific erroneously recovers several recurring costs in NRCs, its NRCs are TELRIC-compliant.

II. PACIFIC'S VERTICAL FEATURES CHARGES ARE NOT TELRIC-COMPLIANT.

11. I also demonstrated in my initial declaration that Pacific's recurring cost study – on which its current rates are based – further violates TELRIC principles by including costs

⁶ *See, for example*, the March 4, 1998 Declaration of Scott Pearsons for Pacific Bell in the OSS/NRC phase of the

for vertical features that it does not actually incur. In particular, Pacific's switch rates are inflated because it charges competitive LECs separate fees, which range from \$0.09 to \$0.53 per month for *each vertical feature* (e.g., "caller ID," "three way calling" and "call forwarding"), even though Pacific's incremental cost of providing vertical features is zero (or, at most, quite small).

12. I also demonstrated that vertical features generally are provided by using hardware and software features that are already built into the switch. The cost for most of this functionality is included in the up-front price that ILECs pay for switches. And Pacific does not incur any incremental switch-related cost to provide an additional feature to its customers, other than perhaps a very small cost to "activate" that feature for the customer (which is usually recovered through a small NRC). But once the feature is activated, there is no additional cost to Pacific – the software in the switch takes care of all of the work, resulting in no additional cost to Pacific. It simply makes no sense for Pacific to recover the costs of vertical features separately from the recovery of the cost of the switch. It should not be surprising, therefore, that in nearly all states except California, ILECs do not separately bill vertical features to competitors, but instead recover the cost for access to vertical features in the same manner that they recover other switch costs.
13. Pacific's response to this showing is an unsupported statement that it does incur nontrivial recurring costs associated with usage. Predictably, however, Pacific is unable to cite to a single source for proposition. Nor does Pacific bother to explain why it recovers vertical features costs in a manner that is different from virtually every other

state – including its own SBC affiliates. And Pacific does not try to square its position with this Commission’s findings in the *Local Competition Order* (§ 414) that “the record [in the Local Competition proceeding] indicates that the incremental costs associated with vertical switching features on a per-line basis may be quite small.” This Commission’s finding is entirely consistent with the fact that Pacific’s own Texas counterpart – Southwestern Bell Telephone – has filed new cost studies with the Texas Public Utility Commission that do not report any separate feature costs, but instead include vertical features as part of the port.⁷

14. The reason why Pacific cannot legitimately justify its separate charge for vertical features is because the bulk of Pacific Bell’s supposed costs per feature consists of expense “proxies” that Pacific claimed that it incurs only because it treats each UNE feature as a separate service. For example, a large portion of Pacific’s cost per feature is its supposed cost to “manage” and bill each of the individual feature “products.” But such feature-related expenses could only exist (assuming they exist at all) because Pacific Bell insists on billing each single feature separately. Hence, Pacific has managed to create entire categories of cost that need not exist at all for its competitors through its unique proliferation of individual UNE rate elements.

15. The anticompetitive nature of Pacific’s non-TELRIC vertical features charge cannot be overstated. The artificially high prices for vertical features that Pacific currently imposes on competitors create a substantial opportunity for Pacific to exercise its market power

⁷ Direct Testimony of Dale A. Lundy on behalf of Southwestern Bell Telephone L.P. in Tex Public Utility Commission Docket No. 25834, November 4, 2002, at 10. Mr. Lundy identifies the cost of features (which are included in the analog port cost) as feature software investment and, in certain cases, feature hardware investment. *Id.* at 12. Nowhere does he indicate that there is any feature-specific usage cost.

and shut out potential UNE-based competitors. Pacific can choose whether and, if so, how it incurs product management costs on the retail side (by deciding to offer features individually, rather than as part of packages), whereas competitors must pay Pacific to “product manage” individual features, regardless of the manner in which the competitors offer those features to their retail customers. Consequently, UNE-based competitors in California would be unable to provide retail local telecommunications services that include vertical features at prices that would be competitive with Pacific.

16. In this regard, there is a potential for Pacific to implement a price squeeze and freeze out competitors from offering local telephone service with vertical features that rates that are competitive with Pacific. In particular, Pacific does not incur these separate and largely artificial vertical features costs that it forces its competitors to pay through UNE rates. Even if Pacific imputes these costs to its retail arm, such imputation represents nothing more than shifting money from Pacific’s left corporate pocket to Pacific’s right corporate pocket, and not a true cost to Pacific.
17. Dr. Lehman notes that no price squeeze currently exists because current retail rates for vertical features substantially exceed Pacific’s current wholesale rates for vertical features. But that argument completely misses the point. First, Pacific enjoys a competitive advantage because, at any given price, its profit from the sale of vertical features exceeds the profit of its competitors from the sale of those vertical features. That excess profit, of course, can be used to subsidize other services, engage in additional marketing activity, or any other host of activities that provides Pacific with a competitive advantage over its competitors. Second, the fact that Pacific’s retail rates for individual vertical features *currently* exceed wholesale rates does not preclude Pacific from

drastically lowering those retail rates, particularly through low-priced packages of multiple features,⁸ to implement a price squeeze after obtaining section 271 authority. Thus, Dr. Lehman's claim that the Commission can simply ignore the anticompetitive nature of Pacific's non-TELRIC vertical features costs is without merit.

⁸ Even today, Pacific offers packages of vertical features at combined prices that are far lower than the sum of the individual feature prices cited in Dr. Lehman's affidavit.

VERIFICATION PAGE

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

/s/ Terry E. Murray

Terry E. Murray

Executed on: November 26, 2002