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December 11, 2002

Via Electronic Delivery

Ms. Marlene Dortch, Secretary
Federal Communications Commission
445 12th Street, SW – Lobby Level
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; and 98-147

Dear Ms. Dortch:

On November 18, 2002, SBC proposed to the Commission a transition plan under which it would continue to make available the functional equivalent of UNE-P for two years after the elimination of unbundled switching from the Commission's UNE list. SBC showed further that, under this plan, CLECs would be able to earn reasonable margins on residential retail service.[1] Specifically, SBC demonstrated—using realistic estimates of CLEC residential retail rates, non-retail revenue opportunities (access, SLC, etc.), and CLEC costs—that its proposed $26 rate would allow CLECs the opportunity to earn healthy margins of 15% to 34% for the customers they typically serve, and even higher margins when serving the heaviest users of vertical features and long distance services.[2] SBC further explained that these margins are more than sufficient, considering that CLECs incur virtually no incremental capital investment when using UNE-P functionality to provide local residential service. Two days later, AT&T disparaged SBC's compromise proposal, calling it a "competitive dead-end."[3]

[1] *See Letter from Jay Bennett, Executive Director—Federal Regulatory, SBC, to Marlene H. Dortch, Secretary, Federal Communications Commission*, November 19, 2002 ("SBC Proposal").

[2] *Id.*, Att. at 8.

[3] *Letter from Joan Marsh, Director, Federal Government Affairs, AT&T, to Marlene Dortch, Secretary, Federal Communications Commission*, November 21, 2002, at 1 ("AT&T 11/21 Letter").

That AT&T was so quick to attack SBC's proposed transition plan should come as no surprise. AT&T has told analysts that, consistent with its strategy of "maximizing cash," it will not offer local residential service unless it can earn at least a 45% gross margin on such service.[4]

AT&T obviously could not complain to the Commission about the unavailability of 45% margins on virtually no investment. Instead, it attacked SBC's proposed transition plan with a spreadsheet that purports to show that AT&T would face "negative margin opportunities" if the Commission adopted SBC's plan. As shown below, AT&T's spreadsheet is a model of hypocrisy and disingenuous advocacy. It fails to reflect the service packages that AT&T and other UNE-P CLECs actually sell in the marketplace or the revenue streams available from the high-value customers they target. It also contains incorrect data even for the fictitious business model it represents.[5]

- ♦ AT&T Failed to Include Long Distance and Access Revenue Associated with Its Provision of Long Distance Services

The most glaring deficiency in AT&T's spreadsheet is its failure to account for long distance and access revenue associated with the combined local and long distance retail packages that AT&T and other CLECs sell to residential customers. Indeed, AT&T omits not only interLATA long-distance and access revenue, but intraLATA toll and access revenue as well, from its margin analysis. These omissions cannot be squared with the retail services AT&T and every other UNE-P CLEC actually market and sell to residential customers.

AT&T's lead UNE-P-based residential offering in SBC's states is its "Local and Long Distance Together" service. AT&T is aggressively promoting this combined local and long distance service in television commercials, print advertisements, and mass mailings. Attached hereto as Exhibit 1 are numerous examples of marketing materials used by AT&T to tout this service in SBC's states where UNE-P is most heavily used by CLECs: Michigan, Illinois, Ohio, Texas, and California. As those materials show, AT&T not only promotes the convenience of its combined offering of local and long distance service by telling customers they can "get all [their] calls" with AT&T and to "get it all" with AT&T, but also sends checks to consumers that, if cashed, will switch *all* of a customer's services—local, local toll, and long distance—to AT&T.

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[4] *Transcript,* Q2 2002 AT&T Earnings Conference Call—Final at 19 (July 23, 2002)("AT&T Earnings Transcript").

[5] On November 25, WorldCom submitted an *ex parte* letter echoing AT&T's claim that SBC's compromise proposal would offer negative margins. Like AT&T, WorldCom bases its claim on retail prices for basic POTS service. But even WorldCom concedes, albeit tacitly, that this argument is a red herring, when it follows this claim with a discussion of local and long-distance packages. The fact of the matter is that SBC *showed* that CLECs could earn healthy margins with packages of local and long distance services priced at $40-$60 per month. MCI does not even purport to challenge this showing, and it certainly does not explain why it could not continue to offer The Neighborhood – which is priced at either $50 or $60 today – under SBC's proposal.

There are several reasons CLECs focus their marketing on bundled service packages. One is that customers want them. As AT&T itself told the Commission: "Consumers buy bundles—Local and LD together just makes sense to them."[6] Another is that bundles help CLECs reduce churn. A customer that purchases a bundled service package is less likely to switch to another carrier than a customer who purchases stand-alone services. A third reason is that under a UNE-P regime, CLECs that provide both local and long distance services reduce the cost of their long distance offerings by eliminating originating access costs. In addition, UNE-P CLECs eliminate terminating access charges for long distance calls between their own subscribers and collect terminating access charges for long distance calls from customers of other long distance carriers. Significantly, and in specific recognition of the importance CLECs have attached to this benefit of the UNE-P, SBC's transition proposal treats access charges just as they would be treated under a UNE-P regime.

None of this is new. Five years ago, AT&T's Senior Vice President and General Counsel, John Zeglis, recognized the value proposition of using UNE-P functionality to provide bundled services when he laid out to the investment community the tremendous margins available to AT&T by using the UNE-P to provide packages of services to residential customers.[7] After showing that a 26% resale discount "[g]ives you a chance to market a combined local and long-distance package,"[8] he went on to discuss how the UNE-P makes much higher margins possible. He used as an example "a consumer that buys $25 of long-distance and five dollars of local toll service per month."[9] He noted that, by using the UNE-P to serve that consumer, AT&T could earn $20 in local service fees, $3.50 for the subscriber line charge, $30 in toll charges, and save $10 in access charges to boot – all told, a $63.50 value.[10] He then went on to note that "none of this is the right way to look at the new AT&T's business. "We are more than an all distance business. On top of that all distance stack of revenue we intend to add Internet service, information services, we intend to add anything that requires local connectivity."[11]

To be sure, AT&T's access costs, and thus its savings, are lower today than they were at the time of the Zeglis presentation, and long-distance prices have come down as well. The bottom line, though, is the same: it makes much more sense for AT&T to sell packages of services, rather than stand-alone POTS service, to consumers, and that is what AT&T does. Indeed, in AT&T's Second Quarter 2002 Earnings Conference Call, Betsy Bernard, AT&T's

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[6] *Letter from Joan Marsh, Director, Federal Government Affairs, AT&T, to Marlene Dortch, Secretary, Federal Communications Commission,* October 4, 2002, Att. 3 at 3.

[7] *Transcript*, AT&T Investment Community Meeting at 5 (March 3, 1997).

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

Consumer Services President and CEO, characterized AT&T's combined long distance and local package as its "lead initiative."[12]

Nor is AT&T alone in using the UNE-P to sell combined residential local and long distance services. Virtually every UNE-P CLEC targets the same residential customers that AT&T targets. MCI's local offering, The Neighborhood, for example, is a combined offering of residential local, intraLATA toll, and long distance service.[13] Other UNE-P CLECs, such as TalkAmerica and Birch, also offer residential local service as part of a combined local and long distance service.[14]

Because AT&T, WorldCom, and other UNE-P CLECs promote bundles of local and long distance service, rather than stand-alone local, residential service, it should come as no surprise that these bundled packages are primarily what customers buy from them. SBC regularly conducts interviews with customers who have left SBC for other carriers, and the most recent of those interviews reveal that more than 80% of SBC customers who switch to a CLEC subscribe to that CLEC not only for local service, but also for local toll and long distance services. In short, common sense and marketplace evidence indicates that AT&T and other CLECs use UNE-P to sell residential customers combined retail offerings of local and long distance services. It is, therefore, inappropriate for AT&T not to include in its CLEC margin calculations toll revenue and access revenue and cost savings associated with long distance services.

SBC estimates that by omitting long distance revenue, AT&T underrepresented its potential revenue by at least $15 per line, and probably more. In attempting to counter evidence that UNE prices in the SBC region do not permit SBC to recover its costs, AT&T has argued that any such losses are offset by an average of $11.69 per line in interLATA toll revenues.[15] Presumably, the high-margin customers AT&T targets for its bundles of local and long distance service generate even higher long-distance revenues. Taking AT&T's figure at face value, however, would require an upward adjustment of $11- $12 per line per month to account for the interLATA toll revenue AT&T obtains from such customers. In addition, this figure must be revised to account for intraLATA toll revenue, which SBC estimates is $3-4 per line per month, for a total upward adjustment in the range of $15 to account for long distance revenue.

Moreover, AT&T not only understated its *customer* long distance revenue, but also appears to have omitted entirely the access revenue and cost savings it realizes when it provides long distance services. As Mr. Zeglis indicated, AT&T not only gains terminating access revenue as a UNE-P CLEC, it also avoids all originating access and some terminating access costs for its local customers who subscribe to AT&T long distance services—in other words, the

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[12] *AT&T Earnings Transcript* at 11.

[13] *See* Ex. 2.

[14] *See* Ex. 3.

[15] *Letter from Joan Marsh, Director, Federal Government Affairs, AT&T, to Marlene H. Dortch, Secretary, Federal Communications Commission*, September 30, 2002, Att. 1 at 6 ("AT&T 9/30 Letter").

very customers AT&T targets and the services it sells. SBC estimates that by failing to reflect the fact that it uses UNE-P to sell bundled packages of local and long distance services, AT&T omitted an additional $1.50 or more in access revenue and cost savings from its margin calculations.[16] Thus, on the whole, AT&T understated its revenue estimates by $16.50 or more by failing to reflect the packages of local and long distance services that it sells to its customers.

- AT&T Also Underestimated Its Local Revenues

AT&T's analysis also underestimates the revenues available from the local component of the services offered by CLECs. Specifically, AT&T's analysis does not reflect the fact that AT&T successfully targets high-end customers – that is, customers who purchase multiple vertical features and other services in addition to basic POTS and long distance services.[17]

The revenue estimates used by AT&T in its November 21st *ex parte* are the same as the estimates used by AT&T in its September 30, 2002, *ex parte* submission to the Commission.[18] Belying its claim that its spreadsheet was "built using actual, verifiable data,"[19] AT&T has never fully identified the source of its data or the manner in which they were collected, nor has it made this information available to the Commission. Thus, while AT&T claimed in its September 30th *ex parte* that its features revenue data come from a "TNS Telecoms Bill Harvesting database,"[20] AT&T has never actually provided the data that it allegedly obtained from the TNS database and used in its September 30th *ex parte* calculations. Nor has it identified specifically what information it used from the TNS database, the characteristics of that information (*e.g.*, when it was harvested, how it was harvested, etc.), or whether AT&T performed any calculations or revisions to the information in the database.

The reason AT&T has never provided this or any of the data it used in constructing its margin calculations is self-evident. The customers whose bills ostensibly were harvested are not AT&T's own local customers. Indeed, AT&T would have no reason to rely on TNS data, as opposed to its own, if it actually were providing a revenue estimate for its own customers. Instead, AT&T apparently has purported to provide average local service revenue per line for all residential customers, including the low-end customers that AT&T and other CLECs eschew. Aside from the fact that this number is significantly lower than SBC's own data regarding average local revenues across its entire residential customer base, these data are obviously

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[16] Moreover, Legg Mason noted that even AT&T's access revenue estimates are understated in that they do not reflect the high value profile of AT&T's targeted long distance customers. *AT&T Pleads its UNE-P Case*, Legg Mason Report at 2 (September 18, 2002).

[17] Moreover, SBC estimates that AT&T's estimates of subsidy and other regulatory revenue are too low. SBC estimates that AT&T's figures should be at least $1.25 per line higher.

[18] *See AT&T 9/30 Letter*, Att. 1 at 5.

[19] *AT&T 11/21 Letter* at 1.

[20] *Id.* at 3.

irrelevant to any calculation of the revenue opportunity available to AT&T and other CLECs under the SBC proposal.[21]

If AT&T had provided estimates of the local revenue streams it obtains from the customers it actually serves, those estimates would be higher because of the revenue generated by vertical features and other non-POTS services purchased by AT&T's customers. As Betsy Bernard has admitted, AT&T's strategy in the marketplace is to use the UNE-P to retain its "high valued customers" and to attract other such customers from its competitors.[22] Ameritech data shows that AT&T and other CLECs are, in fact, successful in this endeavor. A study by Ameritech of the average local revenue that Ameritech had received from residential customers who switched their service to a UNE-P CLEC was significantly higher than Ameritech's average local revenue for all of its residential customers.[23]

That is not say that AT&T has not *tariffed* basic POTS offerings. But what AT&T tariffs and what it aggressively promotes are two very different things. For example, AT&T claims to offer basic local service for $15.00 in Texas,[24] but AT&T does not actively market this offering. In fact, a consumer who accesses AT&T's web site would search in vain for any mention of it.[25]

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[21] SBC estimates that its average revenue per line for local service, including local line and usage charges, EUCL and regulatory assessments, vertical and non-regulated services, and access charges are between $30 and $35, significantly higher than the $27 average estimated by AT&T.

[22] *AT&T Earnings Transcript* at 10. Prior to joining AT&T, David Dorman likewise talked about how the UNE-P would be used by CLECs to target high-end customers:

> So if you do something new and innovative, such as building a fiber coaxial network, you must unbundle it into pieces and offer those pieces to your competitors on any technically feasible basis for your incremental cost. It's hard to imagine a more perfect way to stifle competition. Why would you want to spend billions of dollars building a new network if your competitors can say: "I don't want all that other stuff. I just want the wires from her house and his house because they spend $200 a month. And I don't want your wires to low-income areas because those people only spend about $5 a month."

Telecom's Tragic Reform Tale, The Big, The Bad and The Ugly at 5 (March 16, 1998).

[23] *See Letter from Brian J. Benison, Associate Director, SBC, to Marlene H. Dortch, Secretary, Federal Communications Commission*, September 6, 2002, Att. 1 at 16.

[24] *Letter from Joan Marsh, Director, Federal Government Affairs, AT&T, to Marlene Dortch, Secretary, Federal Communications Commission,* October 4, 2002, Att. 3 at 7.

[25] From www.att.com, a consumer who clicks on "consumer" can then click on "local service." From there, a Texas consumer who enters his or her phone number is presented with three AT&T local offerings: a $25.00 per month package of local service plus three features (which AT&T mentions in its October 4th *ex parte*), a $27.00 per month package of local service plus 5 features, and a $32.00 per month package of local service plus 10 features (neither of which AT&T mentions). AT&T also fails to mention that the $80.00 check it offers to consumers to switch to its $25.00 package also requires them to choose AT&T for long distance services). Even if a consumer had the wherewithal to search for AT&T's

The fact is that regardless of the local services that may be available to customers who know enough to ask AT&T about them, AT&T markets, sells, and obtains revenue from service packages that include high value vertical features and other non-POTS services.

AT&T's spreadsheet does, in fact, claim to reflect revenue from basic service plus features, but the local service revenue estimates used by AT&T in its spreadsheet are impossible to square with the rates of the local service plans AT&T promotes in SBC's states. AT&T actively markets two residential local service plans with features in Michigan, one for $31.00 per month, and the other for $27.00 per month—much higher than the $24.18 average revenue per line estimate used by AT&T in its spreadsheet.[26] Similarly, AT&T used in its spreadsheet an average revenue per line in Ohio of $20.78 and in Texas of $19.96, but the prices for the local service packages that it promotes in Ohio are $25.00, $26.00, and $29.00; and the prices for the local service packages that it promotes in Texas $25.00, $27.00, and $32.00.[27]

AT&T's spreadsheet thus not only omits revenue associated with long distance and access services, it also understates the revenue from the local component of the services AT&T and other UNE-P CLECs market and sell.

Looking at the whole picture, a review of CLEC prices for combined packages of local and long distance services demonstrates that SBC's estimate of $40 to $60 in revenue is a conservative estimate of the revenues available to CLECs. MCI's The Neighborhood is priced at either $50.00 or $60.00, depending on the state—well within the range used by SBC.[28] SBC's range also is consistent with AT&T's unlimited Local Plus Long Distance Offers (local service plus AT&T Unlimited long distance plan), which in California, Michigan, Illinois, Ohio, and Texas are priced between $43 and $50, plus 7¢ per minute for long distance calls to non-AT&T customers.[29] SBC's revenue estimates are thus far more appropriate than the understated local only revenue estimates used by AT&T.

- ♦ AT&T Distorted the SG&A Calculation

Finally, the SG&A estimates used by AT&T demonstrate that AT&T will go to any lengths in its attempt to mislead the Commission about the profitability opportunities it enjoys using UNE-P functionality to target high end residential customers. In its November 18th

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tariffed local service offerings in Texas to try and find a basic local service rate, he or she would find that AT&T's "[t]ariffs are not posted on the web for this state at this time." *See* Ex. 4. The figures in AT&T's October 4th *ex parte* are also misleading in another respect. AT&T fails to mention that consumers pay (and thus AT&T obtains as revenue) an additional $.07 per minute for all calls under the One Rate plan and for all calls to non-AT&T subscribers under the AT&T Unlimited plan.

[26] *See* Ex. 5.

[27] *Id.*

[28] Ex. 2.

[29] *See* Ex. 5.

presentation, SBC used a 20% of total revenue estimate for SG&A costs. This is a common industry standard estimate of SG&A costs.[30] AT&T claims that the SG&A costs in its spreadsheet are "per SBC low estimate." But instead of calculating SG&A as 20% of its own revenue estimates per state, AT&T used the number ($9.60) that SBC calculated using its higher (and more reasonable) revenue estimates, and AT&T hard-coded that in each line of its calculations as the SG&A cost per state. In doing so, AT&T effectively used an SG&A estimate that is, on average, 35% of its own revenue estimates. AT&T cannot have it both ways. It cannot argue that SBC's revenue estimates are overstated but then calculate SG&A based on those estimates, and its suggestion that 35% SG&A costs are "low" is absurd. Indeed, this kind of claim is indicative of the overall lack of credibility of AT&T's analysis.

- Conclusion

It is unfortunate that rather than engage in serious discussion on the merits of a UNE-P transition plan, AT&T has chosen the path of tired rhetoric and misleading and inaccurate statistics. SBC stands by its proposed transition plan and its estimates of the potential CLEC margins available under its plan. SBC believes that its plan offers the Commission a realistic and meaningful approach to a national transition plan for a sustainable model for local competition.

Sincerely,

James C. Smith

Enclosures

[30] Moreover, SBC's estimate was overly conservative in that SBC applied the 20% to total revenue, including toll revenue, and SBC included a separate cost estimate for the provision of long distance service, which likely already includes some or all of the SG&A costs of providing long distance service.

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