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Via Electronic Submission

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW – Lobby Level
Washington, D.C. 20554

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

Dear Ms. Dortch,

In a recent *ex parte*, AT&T attacks the cost model and margin analysis submitted by SBC to demonstrate that facilities based CLECs can profitably use their own switches in conjunction with UNE loop serving arrangements to serve residential customers. As demonstrated below, AT&T's criticisms lack merit. As the results of SBC's analysis demonstrate, facilities based CLECs can profitably serve residential customers, and there is no basis for the Commission to unbundled local switching.¹

Like WorldCom before it, AT&T continues to insist that profit margins "are not a rational test for impairment."² Not only is AT&T wrong, it apparently has amnesia. In Commission Section 271 proceedings, AT&T has argued that profitability is the central component in determining the viability of CLEC market entry. Specifically, in the Declaration of Michael Lieberman submitted on behalf of AT&T in the Kansas/Oklahoma 271 proceeding, Mr. Lieberman informed the Commission that the "viability of a UNE-based offering – that is,

¹ AT&T and other CLECs also have claimed in this proceeding that they are impaired without access to unbundled local switching as a result of hot cuts. SBC has thoroughly discredited that claim. Specifically, contrary to assertions by some CLECs, including Birch, *SBC does not cap the amount of numbers it will port in any wire center in any given day or the number of hot cuts it will perform in any wire center in any day.*

² Letter from Joan Marsh, Director Federal Government Affairs, AT&T to Marlene Dortch, Secretary, Federal Communications Commission ("AT&T February 4 Letter"). AT&T's arguments are essentially the same as those raised by WorldCom. *See, e.g.,* Letter from Gil M. Strobel, Lawler, Metzger & Milkman, LLC to Marlene H. Dortch, Secretary Federal Communications Commission (Jan. 27, 2003)("WorldCom Letter").

whether it makes sense for AT&T (or any other entrant) to commit its shareholders' capital to that enterprise – turns on” a “margin analysis” of the sort set forth by Mr. Lieberman in his Declaration.³ Mr. Lieberman describes such analysis as one in which:

“a carrier considering whether to enter the local services business in a state (or to continue to participate in that business) must determine *whether revenues attributable to the service will exceed the costs of providing the service* by an amount sufficient to generate a return that is commensurate with the expectations of investors concerning risks and returns and with competing uses for the capital.”⁴

Although Mr. Lieberman focused specifically on the economic viability of a UNE-P based entry strategy, he makes clear that “the same type of analysis” would be used for “any other substantial investment decision,”⁵ presumably including the decision whether to pursue a facilities-based, UNE-L strategy. Thus AT&T itself has recognized the merits of a profitability analysis in determining whether a CLEC may economically serve customers using its own facilities. Its recent about-face on that score should be seen for what it is: a self-serving and disingenuous attempt to perpetuate a UNE-P policy that substitutes synthetic competition for real competition.

AT&T's about-face is not only insincere, it also rests on a view of the Act that has been soundly repudiated by both the Supreme Court and D.C. Circuit. Both courts were presented with previous Commission decisions that defined impairment with reference to the relative cost of providing services with and without UNEs. Both courts rejected this analytical framework. The Supreme Court held that the mere fact that it may be cheaper to use UNEs than UNE alternatives says nothing about whether a competitor reasonably could provide service using the alternative. The D.C. Circuit similarly held that cost disparities alone do not constitute impairment because “average unit costs are necessarily higher at the outset for any new entrant into virtually any business.”⁶ In order to survive judicial review, the Commission must move

³ Declaration of Michael Lieberman on Behalf of AT&T Corp., *In the Matter of Application of SBC Communications Inc, Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Kansas and Oklahoma* ¶ 3 (Nov. 15, 2000) (“Lieberman Declaration”)

⁴ *Id.* (Emphasis added.)

⁵ *Id.*

⁶ Although AT&T and WorldCom claim that the ostensible cost differences they cite are not the sort of cost differences that confront any new entrant in any industry, they offer nothing to back that up. Instead, they seem to suggest that sunk costs are somehow unique and a source of impairment, in and of themselves. But as Dr. Shelanski points out in his January 14th letter to the Commission, “exit from a market is rarely costless, and the risk of stranding cost is a normal part of business in most industries. In fact, it is a risk that incumbents face as well.” Indeed, in the long run, ILECs face all of the same sunk costs, including the cost of performing cross connects, *i.e.*, hot cuts, for all customers (including customers who activate service for the first time as well as customers who switch to the ILEC from

beyond the flawed analyses espoused by AT&T and WorldCom. SBC has shown, using the very type of profitability analysis that AT&T itself has previously espoused, that CLECs can use their own switches in conjunction with UNE loops to profitably serve customers. That showing demonstrates that CLECs are not impaired without access to unbundled local switching.

In any event, even if it were appropriate to compare ILEC costs with CLEC costs in determining impairment – which, as noted above, it is not – neither AT&T nor WorldCom has done so. Instead, they compare TELRIC costs with what appears to represent their claimed *embedded costs over the short run*. In other words, in a transparently self-serving fashion, they have rigged the analysis by comparing apples and oranges.

As an initial matter, TELRIC costs do not even purport to represent incumbent LECs' actual costs. Rather, they represent the *hypothetical* costs of an optimally efficient competitor. As Dr. Shelanski pointed out in his January 14th letter to the Commission,

Once the hypothetical nature of TELRIC is acknowledged, then WorldCom's economic analysis becomes irrelevant to the question of impairment. There is nothing conservative about comparing one hypothetical model with another if an ILEC's real costs are in fact much higher than TELRIC prices for UNE-P. And one would be hard pressed to assume a correspondence between an ILEC's operating costs and UNE-P prices given the great difference in the latter that exists across jurisdictions.⁷

But the flaws go even deeper than that. TELRIC represents the hypothetical *long run incremental costs* of an optimally efficient competitor. There is no value in comparing the long-run incremental cost, on the one hand, with *short run embedded costs*, on the other. Those are completely different measures of costs, and one would always expect long run incremental costs to be lower. The "cost" comparison offered up by AT&T is thus fundamentally flawed.

In the final analysis, though, common sense itself demonstrates the fallacy of AT&T's position. If cost differences in and of themselves created impairment, one would never expect to see any competition in any industry that requires up-front sunk costs.⁸ A new entrant would always be impaired. That simply won't fly. Indeed, the fact that CLECs are, today, serving

facilities-based CLECs). Thus, as Dr. Shelanski says, "[t]o recognize these costs as 'impairment' simply because they are sunk does not make economic sense."

⁷ See Letter from Jay Bennett, Executive Director – Federal Regulatory, SBC Telecommunications, Inc. to Marlene H. Dortch, Secretary, Federal Communications Commission (Jan. 14, 2003) AT&T's argument in its February 4th *ex parte* that the Supreme Court has upheld use of TELRIC pricing is inapposite to this conclusion. That TELRIC has been upheld as an acceptable means of UNE pricing does not refute the fact that it does not represent the cost that SBC actually incurs in providing service to its customers.

⁸ As Professor Shelanski put it, "[c]ost disparities are common, if not the norm, among competing businesses," and, in particular, new entrants "will almost always have to incur costs that incumbents no longer face."

customers with their own switches and UNE loops—despite the fact that the cost to do so is higher than the UNE-P rates CLECs could obtain to serve those very same customers—demonstrates the fallacy of basing impairment on a comparison of UNE-P rates with CLEC costs.⁹ As Dr. Shelanski concludes, “It would be a weak and economically meaningless definition of impairment that hinged on such normal and ultimately non-determinative cost differences.” The Commission should reject the fundamentally flawed approach advocated by AT&T and WorldCom, and it should focus instead on the determination of whether facilities-based CLECs can economically serve customers. As SBC demonstrated, facilities-based CLECs can economically serve customers using their own switches in conjunction with UNE loop serving arrangements. The analysis thus demonstrates that there is no basis for the Commission to unbundled local switching.

The \$40 and \$60 Retail Price Points

AT&T also attacks the price points used by SBC in calculating CLEC revenue opportunities. None of AT&T’s criticisms has merit. AT&T initially complains that the \$40 and \$60 retail price points (and corresponding total revenue estimates of \$48 and \$68) used by SBC in its margin analyses¹⁰ are “hypothetical,” and that SBC’s December 11, 2002, *ex parte* letter justifying these amounts is “devoid of documentation.”¹¹ That is flatly incorrect. SBC attached to its *ex parte* 80-plus pages of evidence documenting CLECs’ retail price points. That evidence amply demonstrates that SBC’s range of \$40 to \$60 is a conservative estimate of actual CLEC residential retail offerings.¹²

AT&T’s only substantive response to this mountain of evidence is its claim that unspecified and undisclosed TNS data show that the \$40 and \$60 price points represent only a fraction of the total number of residential customers. This response is woefully inadequate.

As an initial matter, AT&T’s argument is irrelevant. The fact of the matter is that, even with the UNE-P, CLECs are focusing their marketing efforts almost exclusively on customers

⁹ As shown in the *UNE Fact Report*, CLECs are using their own switches to serve residential customers as well as business customers.

¹⁰ AT&T complains that SBC “lightened the appearance of its burden” by referring to the \$40 and \$60 “without highlighting” that SBC used total revenue amounts of \$48 and \$68. That is simply not true. It has always been abundantly clear that the \$48 and \$68 amounts represent total revenue, including access, SLC, and EUCL, and that the \$40 and \$60 amounts represent retail price points.

¹¹ AT&T implicitly concedes that in estimating potential CLEC revenue, it is appropriate—as SBC demonstrated in its December 11th *ex parte*—to consider the bundled, all-distance (local plus long distance) services that AT&T and other CLECs are selling to customers.

¹² AT&T’s January 15th reference to SBC’s data as coming from “undocumented sources” is laughable. All of SBC’s documents are copies of actual CLEC offerings, including numerous AT&T advertisements, inducements, and mass mailings, and print outs of pages from AT&T’s web site. It is unclear precisely in what manner AT&T believes that SBC’s use of the information contained in those offerings was undocumented.

who purchase combined packages of local and long-distance services and who spend \$40 or more per month. AT&T's claim that the elimination of the UNE-P would deny CLECs the ability to compete for other customers – even if true, which it is not - is thus hypocrisy.

Moreover, SBC's price points are highly conservative, because they account only for *residential* revenue opportunities. In the real world, CLECs using their own switches would serve business, as well as residential, customers. . Business customers, of course, generate more revenue than residential customers. Because SBC's margin analysis did not include business revenues, it is, if anything, overly conservative.

With respect to AT&T's TNS data, AT&T fails to provide any support, other than the terse annotation, "TNS Telecoms Bill Harvesting Data," for its estimate of the "addressable" residential market. AT&T continues its failure from earlier *ex partes* to actually include the data it uses to draw its conclusions. Failing to actually provide the data, AT&T also offers no enlightenment as to precisely what TNS data it used, what time period is represented by its data, the geographic or demographic scope represented by its data, or what, if any, calculations AT&T may have performed on the data after it acquired from TNS.¹³ Without any such information, this data is entitled to no weight.

On their face, moreover, AT&T's statistics are implausible. AT&T suggests that roughly 35% of residential lines generate revenue of \$35 or more for local and long distance services. That is impossible to square with data SBC has presented to the Commission. SBC's data reveal that 50% of SBC's Midwest residential customers spend an average of \$36 or more for local service only (including intraLATA toll).¹⁴ This data comes from SBC's electronic data warehouse, which, in turn, obtains data from SBC's customer billing systems. It thus represents real world statistics of average per line revenues generated by SBC's Midwest residential customers. Assuming an average of \$10 long distance revenue per customer,¹⁵ SBC's data demonstrate that nearly 75% of its residential customers spend \$35 or more per month for local or long distance services.

AT&T also is incorrect when it claims that it does not target high value customers. As an initial matter, as SBC pointed out in its December 11, 2002, and January 27, 2003, *ex partes*, AT&T has itself told investors on more than one occasion that it does target such customers. In addition, AT&T's argument that its marketing efforts "reach *all* classes of customers" is

¹³ AT&T is incorrect in its January 15th assertion that in its December 11th *ex parte* SBC questioned the validity of TNS data. Rather, SBC questions the total lack of verification or justification of the data underlying the statistics reported by AT&T to justify its conclusions.

¹⁴ See Letter from Brian J. Benison, Associate Director Federal Regulatory, SBC Telecommunications, Inc. to Marlene H. Dortch, Secretary, Federal Communications Commission (September 6, 2002).

¹⁵ \$10 is a conservative estimate based on the \$11.69 in revenue assumed by AT&T in its September 24, 2002, "UNE-P vs. 271 LD Entry" *ex parte* presentation. See Letter from Joan Marsh, Director Federal Government Affairs, AT&T, to Marlene Dortch, Secretary, Federal Communications Commission (Sept. 30, 2002).

disingenuous. The fact that AT&T's television, print, mass mailings and internet advertisements *reach* all customers is irrelevant.¹⁶ What is relevant is that the services described in those advertisements are AT&T's high revenue services. It is telling that in the face of the numerous documents SBC provided to demonstrate that AT&T markets its high value services, AT&T has yet to provide a single document to the contrary showing that it actively markets is lower value services. The fact is that it does not, and it has said that it does not. Using AT&T's own metaphor from its February 4th *ex parte*, it does not "sow and plant the whole field." Rather, it sows and plants the high value crops, and, on occasion it happens to reap a few additional ears from seeds it happens to drop along the way.

Apart from the problems with its data, AT&T's analysis is flawed on a conceptual level as well. In effect, AT&T assumes that the results of SBC's analysis are only valid if every CLEC residential customer in every wire center generates at least \$40 per month in revenue in order to cover the average cost of providing service. That is incorrect.

On February 4, 2003, SBC submitted an iteration of its analysis demonstrating that, even for WorldCom's lowest CLEC market share assumption, facilities based CLECs using their own switches in conjunction with UNE loop serving arrangements can profitably serve residential customers at price points lower than \$40.00. SBC's analysis shows that, with a distribution of customers purchasing services at price points between \$35 and \$60.00, facilities based CLECs face positive margin opportunities.

In addition, SBC's analysis demonstrates that facilities based CLECs are better off serving a distribution of customers that include price points below \$40 than a smaller distribution of customers that includes only higher price points greater than \$40. This analysis reveals the fundamental flaw in AT&T's argument. Even under the smallest market share assumptions, the decreasing incremental cost of providing service makes it profitable to add residential customers at price points lower than \$40.

SBC's February 4, 2003, *ex parte*, also demonstrates that, even if some wire centers may not be profitable for CLECs to serve using their own switches and UNE loop serving arrangements, in the aggregate, CLECs can profitably serve the collection of wire centers in an MSA. For example, even in Saginaw, Michigan—the 102nd largest MSA—facilities based CLECS have positive residential margin opportunities. This result, in conjunction with results of the economic analysis submitted by SBC on January 14th and February 4th, demonstrate that CLECs are not impaired without access to unbundled switching.

¹⁶ SBC did not base its argument that AT&T actively markets to high value customers "solely" on the fact that on its web site AT&T only solicits high value Texas residential customers. SBC based its argument on the fact that in all of its advertisements AT&T focuses on high value customers and that AT&T does not actively market lower revenue services. Specifically, the "media advertising" submitted by SBC, on which AT&T admits it relies most heavily, demonstrates that AT&T actively markets its high revenue services.

Cost Model Assumptions

AT&T also attacks the cost model component of SBC's analysis. It generally asserts that SBC's calculation of collocation costs are no more than half of what is appropriate. There is no basis for AT&T's assertion. SBC's cost model fully accounts for all the cost associated with the virtual collocation arrangements necessary for a facilities-based CLEC to use its own switch in conjunction with UNE loop serving arrangements.¹⁷

As explained in SBC's January 14th *ex parte*, SBC's model assumes that a facilities-based CLEC will use virtual collocation to serve mass market customers because that is the most efficient and cost-effective arrangement for a CLEC that does not already have physical collocation space in a particular wire center.¹⁸ Using SBC's tariffed virtual collocation rates, SBC's model calculates the cost of the virtual collocation arrangements that a facilities-based CLEC would actually use for the GR-303 concentration equipment necessary to serve mass-market customers. In calculating the cost of virtual collocation required for a typical GR-303 DLC architecture, SBC used a standard layout of such equipment. And, contrary to AT&T's assertion, the model fully accounts for all of the virtual collocation space and equipment—including bays and termination panels—a CLEC would need for a typical GR-303 DLC architecture.¹⁹

Also contrary to AT&T's assertions, SBC's model includes the cost of operation and maintenance associated with DS0s, DS1s, power and racking, and termination panels.²⁰ Specifically, the SBC cost model reflects the costs necessary to house and install terminating blocks and cables. The number of termination panels included in the model is based specifically on the number of lines supported by the GR-303 DLC equipment reflected in the cost model. Because all of these costs are based on the actual rates in SBC's state virtual collocation tariffs,

¹⁷ AT&T is correct that SBC double counted some collocation costs. That double-counting, however, *increased* SBC's estimate of CLEC costs and thus *decreased* its estimate of CLEC margins. SBC has corrected its error, and the revised, slightly higher margin estimates are attached.

¹⁸ The SBC model, moreover, is overly conservative in that it assumes a CLEC will have to purchase virtual collocation in each SBC wire center, and it does not discount the cost of collocation to account for the fact that many CLECs already are collocated in many of SBC's wire centers and in ILEC wire centers throughout the country.

¹⁹ AT&T alleges that SBC's collocation costs must be inaccurate because of SBC's statement that DLC equipment capable of serving 2,048 customers could be housed in single bay. As an initial matter, the number of derived lines is not relevant to the cost calculation. The total cost per derived line is the focus of the cost model, and the cost model fully accounts for all costs associated with DLC equipment as verified by the vendor of such equipment. Moreover, there are several DLC vendors, and it *is* possible to have 2,048 lines—and even more—is a 7' bay, depending on the manner in which the bay is equipped.

²⁰ AT&T is correct that SBC's cost model does not assume the use of DSx-3 termination panels, because the model assumes only DS1 transport. Including DSx-3 equipment—and thus DS3 transport—in SBC's cost model, however, would serve to *lower* the overall cost calculated by the model, because, in the aggregate, DS3 transport costs less than DS1 transport.

SBC's calculation of such costs accurately portrays what a CLEC actually would pay in connection with virtual collocation.²¹

With respect to DLC costs, AT&T says simply that SBC's "figures are extraordinarily low." The fact is, however, that SBC's cost model reflects the EF&I cost of actual DLC equipment as confirmed by a vendor of such equipment. SBC's cost model reflects the deployment of all necessary DLC equipment, down to each plug-in. And, as described above, it does include the cost of all equipment that a CLEC would need. It thus fully captures the total DLC costs a CLEC would incur in using its own switch in conjunction with UNE loop serving arrangements.

AT&T's complaints about the "financial assumptions" in SBC's cost model are similarly unavailing. There is no justification for AT&T's proposed 15% cost of capital rather than the 12.19% used in SBC's calculations. 12.19% fully reflects the risks faced by telecommunications providers. The issue of income taxes on the equity component of a cost of capital is also entirely irrelevant. SBC used an effective composite cost of capital of 12.19%; it did not construct a cost of capital using debt and equity ratios. Income taxes on the equity component of the cost of capital are thus implicitly assumed in the 12.19% used by SBC. The financial assumptions in SBC's cost model are appropriate and fully support the overall cost calculations used by SBC in its margin analysis.

Finally, as to both collocation and DLC costs, AT&T complains that SBC's cost model does not include a fill factor. Fill factors, however, would be inappropriate given the nature of the margin analysis performed by SBC and the calculation of per line costs used in that analysis. SBC's margin analysis proceeds from the assumption of certain market shares, which translates into specific numbers of lines. In determining the per line cost for those line counts, SBC's cost model uses the full cost of the minimum amount of equipment that would be necessary for each of the assumed market shares and then divides the full cost of that equipment by the number of lines in each market share. SBC's calculated cost per line thus fully accounts for the fact the collocation and DLC equipment deployed by a CLEC will likely be utilized at less than 100% of capacity.

²¹ The model also reflects costs associated with test equipment and maintenance and monitoring. The model assumes that testing will be performed by means of one of the DS1 ports. It also assumes that SBC will maintain and monitor the equipment, and it includes the costs enumerated in SBC's state collocation tariffs for providing such services.

Respectfully Submitted,

/s/ **Jim Lamoureux**
