

Attachment A: The Verizon Companies

This filing is made on behalf of the Verizon telephone companies and the Verizon long distance companies.

The Verizon telephone companies are the local exchange carriers affiliated with Verizon Communications Inc. These are:

- Contel of the South, Inc. d/b/a Verizon Mid-States
- GTE Midwest Incorporated d/b/a Verizon Midwest
- GTE Southwest Incorporated d/b/a Verizon Southwest
- The Micronesian Telecommunications Corporation
- Verizon California Inc.
- Verizon Delaware Inc.
- Verizon Florida Inc.
- Verizon Hawaii Inc.
- Verizon Maryland Inc.
- Verizon New England Inc.
- Verizon New Jersey Inc.
- Verizon New York Inc.
- Verizon North Inc.
- Verizon Northwest Inc.
- Verizon Pennsylvania Inc.
- Verizon South Inc.
- Verizon Virginia Inc.
- Verizon Washington, DC Inc.
- Verizon West Coast Inc.
- Verizon West Virginia Inc.

The Verizon retail long distance companies are:

- Bell Atlantic Communications, Inc. d/b/a/ Verizon Long Distance
- NYNEX Long Distance Company d/b/a/ Verizon Enterprise Solutions
- Verizon Select Services Inc.
- Verizon Global Networks Inc.

Attachment B

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

In the Matter of)	
)	
Section 272(f)(1) Sunset of the BOC Separate)	WC Docket No. 02-112
Affiliate and Related Requirements)	
)	
2000 Biennial Regulatory Review)	CC Docket No. 00-175
Separate Affiliate Requirements of Section)	
64.1903 of the Commission's Rules)	

**DECLARATION OF
DENNIS W. CARLTON, HAL SIDER AND ALLAN SHAMPINE**

June 30, 2003

I. QUALIFICATIONS

1. I, Dennis W. Carlton, am Professor of Economics at the Graduate School of Business of The University of Chicago. I have served on the faculties of the Law School and the Department of Economics at The University of Chicago and the Department of Economics at the Massachusetts Institute of Technology. I specialize in the economics of industrial organization, which is the study of individual markets and includes the study of antitrust and regulatory issues. I am co-author of Modern Industrial Organization, a leading textbook in the field of industrial organization, and I also have published numerous articles in academic journals and books. In addition, I am Co-Editor of the Journal of Law and Economics, a leading journal that publishes research applying economic analysis to industrial organization and legal matters. In addition to my academic experience, I am a consultant to Lexecon Inc., an economics consulting firm that specializes in the application of economic analysis to legal and regulatory issues.

2. I, Hal S. Sider, am a Senior Economist and Senior Vice-President of Lexecon Inc. I received a B.A. in Economics from the University of Illinois in 1976 and a Ph.D. in Economics from the University of Wisconsin (Madison) in 1980. I have been with Lexecon since 1985, having previously worked in several government positions. I specialize in applied microeconomic analysis and have performed a wide variety of economic and econometric studies relating to industrial organization, antitrust and merger analysis. I have published a number of articles in professional economics journals on a variety of economic topics and have testified as an economic expert on matters relating to industrial organization, antitrust, labor economics and damages. In addition, I have directed several studies of competition in telecommunications industries and have previously testified as an expert on telecommunications matters before the FCC and various state public utility commissions.

3. I, Allan L. Shampine, am an Economist at Lexecon Inc. I received a B.S. in Economics and Systems Analysis summa cum laude from Southern Methodist University in 1991 and a Ph.D. in Economics from the University of Chicago in 1996. I have been with Lexecon since 1996 and have performed a wide variety of economic studies relating to telecommunications and other industries. I have published a number of articles in professional economics journals on issues relating to telecommunications and technology. I am also editor of Down to the Wire: Studies in the Diffusion and Regulation of Telecommunications Technologies (Nova Press, 2003), which addresses from an economic perspective the regulation of new telecommunications technologies. In addition, I have previously testified as an expert on telecommunications matters before the FCC.

II. INTRODUCTION AND SUMMARY

A. BACKGROUND

4. We have been asked by counsel for SBC, Verizon and Qwest to address certain issues raised in the Further Notice of Proposed Rulemaking (FNPRM) in these matters. In this notice, the FCC seeks comments on the “need for dominant carrier regulation of BOCs’ in-region, interstate and international interexchange telecommunications services after sunset of the Commission’s section 272 structural and related requirements in a state.”¹ We address this issue below, along with the related question of whether the regulatory status of the long-distance operations of independent incumbent local exchange carriers (other than BOCs) should hinge on whether those operations are provided through a structurally separate affiliate. We use the term incumbent local exchange carriers or “ILECs” to refer collectively to the BOCs and independent LECs.

1. FNPRM, ¶2.

5. Section 272 of the Telecommunications Act of 1996 requires BOCs provide long distance services through a separate subsidiary for the first three years following approval to provide such services.² Although this provision does not apply to independent local exchange carriers, Commission rules require such carriers to adhere to less strict separation requirements in order to avoid dominant carrier regulation of their long distance services. In the absence of structural separation rules, ILECs would be free to more fully integrate their provision of long distance and other services.³

6. The FCC's FNPRM asks for comments regarding whether the FCC should impose "dominant carrier" regulation on BOCs' provision of long distance services following expiration of separate subsidiary requirements under Section 272. We understand that, if applied to the BOCs and other ILECs, these regulations: (i) could require those LECs to file tariffs, possibly with detailed cost data; (ii) may subject their ILECs' long distance services to price cap regulation; and (iii) would require them to comply with restrictions on market exit.⁴

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2. As explained in the FCC's initial notice in this proceeding, BOCs and their long distance subsidiaries: (i) may not jointly own transmission and switching equipment; (ii) may not share employees or real estate; (iii) may not perform any operating, installation, or maintenance functions for each other; and (iv) must maintain separate books of account; (v) must have separate officers and directors; and (vi) must conduct all transactions on an arm's length basis.) FCC, NPRM in the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket NO. 02-112, FCC 02-148, May 24, 2002, 4-5.
 3. Both SBC and Verizon have estimated that expiration of separate subsidiary rules would result in large savings over coming years. Verizon estimates that it could save "almost \$247 million through 2006 if the separate affiliate restrictions were eliminated today..." Comments of Verizon in the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112, August 5, 2002, pp. 10-11. SBC estimates that it could save "50 percent for personnel in the network engineering, customer care, billing and network operations departments" as well as large additional savings in labor costs. Comments of SBC Communications Inc. in the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112, August 8, 2002, pp. 7-8.
 4. FNPRM, ¶37.

7. In the FNPRM, the FCC notes that “dominant carrier regulation should be imposed on a carrier only if it could unilaterally raise price and sustain prices above the competitive level and thereby exercise market power by restricting its output or by its control of an essential input.”⁵ Based on this perspective, the FCC requests comments on the current scope of competition in the provision of long distance service as well as comments on whether expiration of separation requirements enables ILECs to harm competition by manipulating rivals’ access to the local network. More specifically, the FCC asks whether expiration of structural separation rules would:

- facilitate non-price discrimination by ILECs against their long distance rivals;
- enable ILECs to engage in a “price squeeze” designed to drive their long distance rivals from the market;
- enable ILECs to harm competition by shifting costs from their long distance to local service operations.

B. SUMMARY OF CONCLUSIONS

8. We conclude that permitting the BOCs and independent ILECs to integrate their long-distance and local exchange operations will not adversely affect competition.⁶ Thus, there is no economic basis for imposing dominant carrier regulation on BOCs’ in-region long distance service based on the sunset of Section 272 structural separation requirements, nor is there any economic basis for conditioning the non-dominant status of independent ILECs’ long distance operations on the structural separation of those operations.

5. FNPRM, ¶5.

6. As noted above, separation requirements faced by non-BOC ILECs are less restrictive than those faced by BOCs. Our conclusion that expiration of the BOC rules would not adversely affect consumers necessarily implies that expiration of the less stringent rules faced by non-BOC ILECs also would not result in consumer harm.

9. First, competition in the provision of long distance services has increased dramatically since 1995 when the FCC determined that AT&T should not be subject to dominant carrier regulation.⁷ As discussed in more detail in Section III below, competition along each of the dimensions considered by the FCC has increased:

- The share of wireline subscribers served today by ILEC long distance services (in areas in which they are authorized to provide them) is far smaller today than AT&T's share in 1995, when the FCC concluded that it was not a dominant carrier. More generally, the concentration of wireline long distance services has fallen dramatically since 1995.
- Consumers are increasingly using alternative technologies for long distance communications. Since 1995, wireless services have come to account for a substantial and growing fraction of long distance calls. There also has been tremendous growth in e-mail and instant messaging, which are substitutes for certain long distance calls. Emerging technologies such as "voice over Internet Protocol" (VoIP) and continued growth of existing alternatives to wireline long distance service promise even greater future competition.
- Analysts and carriers agree that there is a glut of capacity in long distance facilities resulting from the deployment of new national fiber optic networks as well as increased capacity of network electronics, which are placing downward pressure on prices.
- Wireline long distance usage has fallen substantially over recent years, from an average of 71 minutes per month in 1995 to 41 minutes per month in 2002. As a

7. The FCC's opinion in that matter addressed the conditions under which a long distance supplier can exercise market power (in the absence of any ability to manipulate access to the local network which, as shown below, is unaffected by expiration of Section 272).

result of both declining prices and usage, average monthly household wireline long distance spending has fallen from \$21.42 in 1999 to \$12.39 in 2002.

10. Second, expiration of structural separation rules would not enable ILECs to adversely affect competition by manipulating access to their local network. As discussed in more detail in Section IV below:

- The expiration of structural separation rules does not adversely affect the ability of regulators to detect non-price discrimination in the provision of access services by ILECs. A number of regulatory safeguards against discrimination would remain in effect following expiration of the structural separation requirement. In addition, ILECs' rivals in the provision of long distance service include large and sophisticated companies that routinely monitor the quality of access services that they receive.
- The expiration of structural separation rules would not give ILECs the incentive or ability to harm competition by engaging in a predatory "price squeeze" designed to drive their long distance rivals from the market. It is widely recognized that successful predation is rare. It is especially unlikely that it could succeed in industries, like telecommunications, in which there are substantial fixed assets that are likely to remain in the industry even if rival long distance companies become bankrupt. The continuing presence of these assets in the industry precludes recoupment of any investment in predation. Moreover, even if an ILEC could drive and keep its competitors from the industry, it would have no assurance of being able to recoup its losses because it would likely face re-regulation of the rates it charges due to its new monopoly status. Because

recoupment is so unlikely, it is highly unlikely that any ILEC would pursue such a strategy.

- Nor would the elimination of structural separation requirements increase ILECs' incentive or ability to harm competition by engaging in cross-subsidization. The FCC raises concerns that cost shifting can (i) facilitate predation or (ii) enable ILECs to avoid regulation of local services. With respect to the former, an ILEC's incentive and ability to engage in predation does not depend on its ability to shift costs. With respect to the latter, cost shifting makes sense only if it enables the ILEC to recover these costs in the price of the regulated service. However, due to price cap regulation of local service rates and intrastate access charges as well as the FCC's CALLS order regulating interstate access charges, prices for regulated services are now set with little regard to costs. In any event, as the FCC itself has recognized, dominant carrier regulation of long distance services is designed to ensure that long distance rates are not too high and is an inappropriate tool for protecting against improper local rate increase.

11. In Section V we elaborate on this point and show that even if one were to (incorrectly) conclude that the expiration of structural separation rules raised competitive concerns, dominant carrier regulation is ill suited to address them. We also discuss how, in the absence of competitive concerns resulting from expiration of the structural separation requirements, imposition of dominant carrier rules would adversely affect competition in the provision of long distance services by discouraging competition and development of new services.

III. THE INDUSTRY HAS BECOME MUCH MORE COMPETITIVE THAN IN 1995, WHEN THE COMMISSION DETERMINED THAT AT&T WAS NOT A DOMINANT FIRM

12. The FNPRM requests comments on the current scope of competition in the provision of long distance service and asks whether the lifting of structural separation requirements risks harm to competition that requires imposition of dominant carrier regulation. This section shows that, using the FCC's framework for evaluating competition in long distance services (in the absence of concerns about manipulation of access to the local network), there is no basis for subjecting ILECs to dominant carrier regulation.

13. The FCC concluded in 1995 that AT&T's long distance service should not be subject to dominant carrier regulation.⁸ Because AT&T did not provide local exchange services, the FCC's review at the time focused exclusively on conditions in the long distance marketplace. We maintain the same approach in this section. As noted above, however, the FNPRM also raises concerns that expiration of the separate subsidiary requirements would give ILECs the incentive or ability to raise long distance prices by manipulating access to their local network through non-price discrimination, executing a predatory price squeeze or engaging in cost shifting. Section IV below shows that there is no basis for these concerns.

A. FRAMEWORK FOR EVALUATING ILECS' DOMINANCE AS LONG DISTANCE SERVICE PROVIDERS

14. The exercise of defining economic markets is undertaken in order to determine the forces that determine price and to determine whether firms can exercise market power. A properly defined market includes all firms whose participation in provision of a service significantly constrains the price under analysis.⁹

8. FCC, Order in the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, FCC 95-427, 11 FCC Rcd 3271, October 23, 1995 (hereafter, "AT&T Non-Dominance Order").

9. According to Carlton and Perloff, Modern Industrial Organization, 3rd edition, "[a] firm (or group of firms acting together) has market power if it is profitably able to charge a price

15. The FNPRM states that rapid changes in the telecommunications industry in recent years have blurred traditional distinctions between wireline and wireless services and between local and long distance services. These changes complicate the delineation of a precise market definition. However, it is not necessary to precisely delineate the current scope of the product market to address the question posed in the FNPRM – whether ILECs should be subject to dominant carrier regulation following expiration of structural separation requirements. This is because, compared to 1995 – when the FCC determined that AT&T was not dominant – the industry has become much more competitive, regardless of the precise market definition used. Therefore there are no changes in competitive conditions that justify imposition of dominant carrier regulation.

16. In the 1995 AT&T Non-Dominance proceedings, the FCC addressed the conditions under which a long distance carrier should be subject to dominant carrier regulation.¹⁰ The Commission's analysis focused on four factors: (1) market share; (2) demand elasticity; (3) supply elasticity; and (4) disparities in size, resources, financial strength and cost structures

(...continued)

above that which would prevail under competition, which is usually taken to be marginal cost.” (p. 610.) A market is defined to include “all those products that are close demand or supply substitutes.” (p. 612) The Merger Guidelines of the U.S. Department of Justice and Federal Trade Commission define two services as being in the same market if a small, but non-transitory price increase by a monopoly provider of one of these services would cause enough buyers to shift their purchases to the other service so as to render the price increase unprofitable. U.S. Department of Justice and the Federal Trade Commission, Horizontal Merger Guidelines, Revised April 8, 1997, Section 1.11. The FCC relies on the same basic framework and specifically applies the Merger Guidelines approach in FCC, Opinion in the Matter of Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interchange Marketplace, 12 FCC RCD 15, 756 (hereafter, “LEC Non-Dominance Order”), ¶25.

10. The FCC's analysis did not address the effect on long distance prices of a long distance carrier's ability to manipulate access to the local network, since AT&T did not provide local exchange services.

among the market participants.¹¹ At that time the FCC highlighted the fact that:

- AT&T's share of subscribers and revenue had rapidly declined in prior years;
- There was significant excess capacity in the long distance industry and competitors could readily expand.¹²
- AT&T's customers readily switched long distance carriers.¹³
- AT&T's large size, financial strength and technical capabilities were not sufficiently unique to confer market power.¹⁴

17. In this section we review the current state of competition in the long distance industry using the same general framework and show that, along each dimension, the industry has become much more competitive than in 1995, when the Commission determined that AT&T was not a dominant firm.

B. RECENT CHANGES HAVE BROUGHT INCREASING COMPETITION TO THE LONG DISTANCE INDUSTRY

18. Along each of the dimensions analyzed by the FCC in the AT&T Non-Dominance proceeding, the long distance industry today faces considerably more competition than in 1995.

- The industry faces increased competition from new wireline service providers, principally BOCs. Although the BOC entry has heightened competition in the provision of long distance services, by any measure their share remains well below that of AT&T in 1995 when AT&T was declared non-dominant. Each BOC (and independent ILEC) is expected to account for less than 10 percent of wireline subscribers nationwide, even after the 271 process is complete. Each BOC's (in-region) share of wireline subscribers is expected to remain far lower

11. AT&T Non-Dominance Order, ¶38.

12. *Id.*, ¶70.

13. *Id.*, ¶63.

14. *Id.*, ¶73.

than AT&T's share in 1995. Overall, industry concentration has fallen sharply and the disparity in the share of subscribers served by the major wireline long distance firms is expected to remain much smaller than in 1995.

- Wireline long distance service providers also face substantial and growing intermodal competition from wireless services. E-mail and instant messaging, which are substitutes for certain long distance calls, provide a significant additional source of competition. As a result, the volume of wireline long distance minutes has declined sharply in recent years. Under these circumstances, attempts by wireline providers to raise prices would result in the loss of minutes to wireless services, e-mail and instant messaging, even if ILECs retained their existing long distance customers.
- There has been a vast increase in industry capacity in recent years resulting from massive deployment of new fiber optic capacity as well as increases in capacity due to advances in network electronics.

19. As shown below, the long distance industry is in the midst of large-scale and fundamental changes. Such circumstances reduce the ability even of firms that account for a large share of industry output to exercise market power (as well as attempts by members of an industry to act in any coordinated fashion). In dynamic industries, firms will have varying perceptions about future demand and supply conditions and, as a result, will have strong incentives to pursue independent strategies. Under these circumstances, current market shares and concentration measures are likely to be poor indicators of a firm's future ability to exercise market power or the ability of firms in the industry to act in a coordinated fashion.

1. The concentration of wireline long distance services has declined dramatically in recent years.

20. According to FCC data, AT&T accounted for roughly 55 percent of long distance revenue, 59 percent of long distance minutes and more than 65 percent of subscribers when the FCC concluded it was not dominant in 1995.¹⁵ The next largest carrier at the time, MCI, accounted for 17 percent of long distance revenues -- roughly 30 percent of AT&T's.¹⁶

21. Since that time, AT&T's share and industry concentration has declined rapidly. Nonetheless, AT&T remains, by far, the nation's largest provider of long distance services. The FCC reports that as of 2001, the most recent data available, AT&T's share of long distance toll service revenue was 37 percent.¹⁷

22. The share of long distance subscribers served by BOCs has been growing rapidly due to the expansion of the number of states in which long distance service has been authorized (and BOCs' success in obtaining new customers). As of June 2003, BOCs have received approval to provide long distance service in 43 states (and Washington, D.C.), which account for more than 80 percent of BOC lines.¹⁸ As shown in Figure 1, BOCs together combined for an estimated 10 percent of wireline long distance subscribers in 2002. This share is projected to increase to 17 percent in 2003 and 26 percent in 2005, following the expected expansion of BOCs' authority to provide long distance service in the remaining states.¹⁹

15. AT&T Non-Dominance Order ¶67 (citing 1994 data).

16. FCC, Long Distance Market Shares Fourth Quarter 1998, March 1999, Table 3.2.

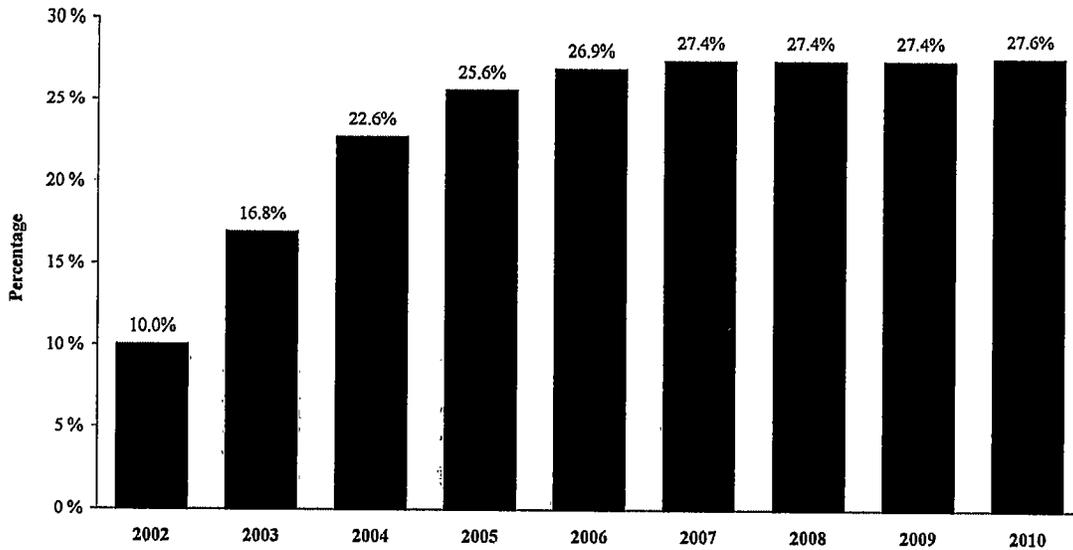
17. FCC, Statistics of the Long Distance Telecommunications Industry, May 2003, Table 7.

18. *Id.*, Table 12, and FCC, Qwest 271 Order for Minnesota, FCC 03-142, June 26, 2003.

19. These figures reflect BOCs' share of all wireline subscribers, which include subscribers of CLECs and independent ILECs. Deutsche Bank estimates that BOCs' share of their own local service customers will reach roughly 38 percent in 2005. Deutsche Bank, "Wireline -- Mid Year Review: Last Man Standing," May 27, 2003, p. 143, 157, 168.

Figure 1:

**Projected Combined RBOC Shares of Wireline Long Distance Subscribers
2002 - 2010**



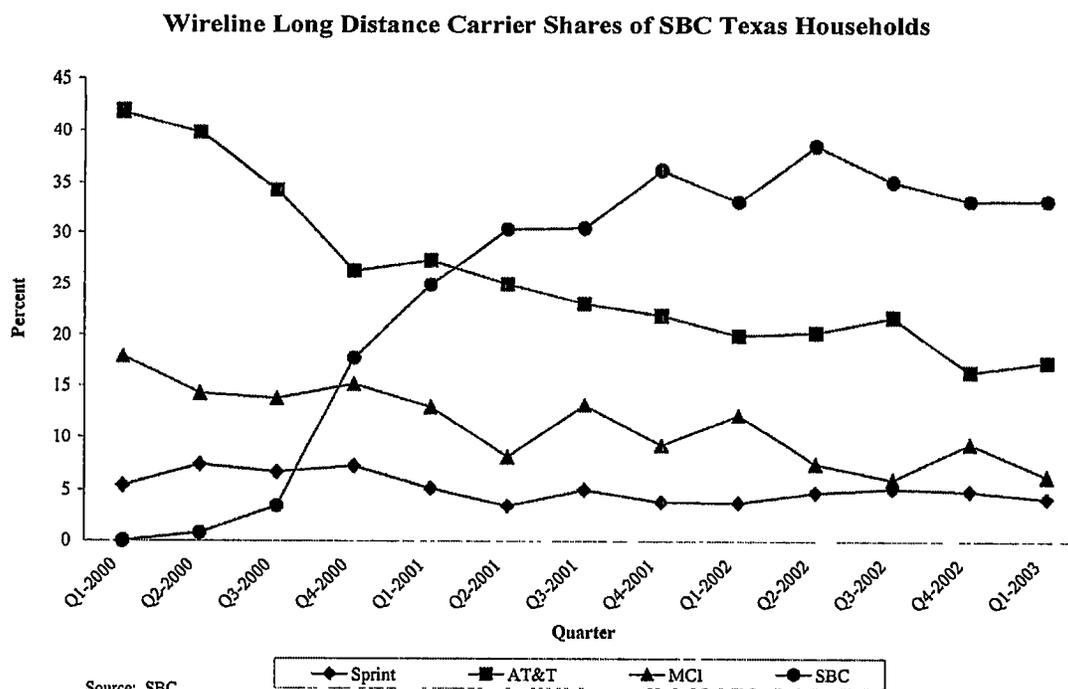
Source: Deutsche Bank, Wireline - Mid Year Review: Last Man Standing, May 27, 2003, p. 185.
Note: 2003-2010 are forecasts.

23. After that date, however, little further growth in BOCs' share of wireline long distance subscribers is anticipated. This is consistent with evidence from states in which BOCs have already entered which indicates that "[t]he experience (thus far) of the RBOCs getting into new markets has been one of significant initial market share gains and then relative stabilization within 18 months of entry."²⁰

24. The rapid growth and subsequent stabilization of BOCs' share following 271 approval is shown in Figure 2, which reports changes in the shares of households served by major long distance carriers in areas of Texas served by SBC following SBC's 271 authorization in June 2000. As the figure shows, SBC's share in its regional footprint went from zero to roughly 35 percent by the fourth quarter of 2001 and has been roughly stable since that time.

20. Deutsche Bank, "Wireline - Mid Year Review: Last Man Standing," May 27, 2003, p. 35.

Figure 2:



25. While Figure 1 reports BOCs' combined share of long distance subscribers, it can also be interpreted as an approximation of the average BOC share in a given region, since only one BOC operates in a given area. Thus, the data imply that, in any given region, BOCs will account for a substantially smaller share of wireline long distance subscribers than AT&T did in 1995. Calculation of BOCs' shares in this way, however, does not necessarily imply that geographic markets for long distance services are regional. Factors such as geographic price averaging requirements and the ability of BOCs to enter out-of-region suggest that the geographic scope of the market may be broader.

26. Even if shares and concentration are calculated on a regional basis in this way, the data reveal dramatic declines in wireline concentration and further show that BOCs' expected share is well below AT&T's national share in 1995, when it was declared to be non-dominant. As shown in Table 1, measured on the basis of the average BOCs' expected in-region share of presubscribed lines, the concentration of the wireline long distance industry has fallen

dramatically since 1995. The Herfindahl-Hirschman Index (HHI) for wireline long distance providers (in a given region) is expected to decline to roughly 1500 in 2005, far below the level of roughly 4700 that prevailed in 1995.²¹ If each BOC's national share is used in the calculation, the HHI falls to about 1,100. These figures also implicitly exaggerate shares and concentration by not accounting for long distance traffic carried by wireless firms (as well as ignoring the impact of e-mail, instant messaging and other forms of "intermodal" competition).

Table 1:

Long Distance Presubscribed Wireline Shares and Approximate HHIs

Year	AT&T	MCI	Sprint	Combined RBOCs	Others	Regional HHI ¹	National HHI ²
1995	66.4%	15.7%	6.4%		11.5%	4,708	4,708
2005	24.4%	14.2%	5.1%	25.6%	30.7%	1,509	1,060

Source: FCC, Long Distance Market Shares Fourth Quarter 1998, March 1999, Table 2.2 (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/LAD/mksh4q98.pdf) for 1995 data; Deutsche Bank, *Wireline Mid-Year Review: Last Man Standing*, May 27, 2003, pp. 185, 143, 157, 168 for 2005 data.

Notes: HHI calculation treats "others" as group of 1% firms.

1/ Regional HHI based on assumption that each RBOC's 2005 share is equal to RBOCs combined national share.

2/ National HHI based on each RBOC's expected nationwide share (Verizon 9.8%; SBC 9.3%; BellSouth 4.0%; Qwest 2.4%).

27. Moreover, the disparity in the number of subscribers served (in a given region) between BOCs and other carriers that is expected in 2005 is much smaller than when AT&T was declared to be a non-dominant carrier in 1995. As noted above, AT&T's revenues were more than three times as large as its next largest rival at that time. The Deutsche Bank forecasts for 2005 indicate that AT&T is expected to account for 27 percent of industry gross toll revenue (which includes long distance, intraLATA toll and private line revenue), BOCs' (combined) will account for 19 percent, MCI will account for 14 percent and Sprint will account for 7 percent.

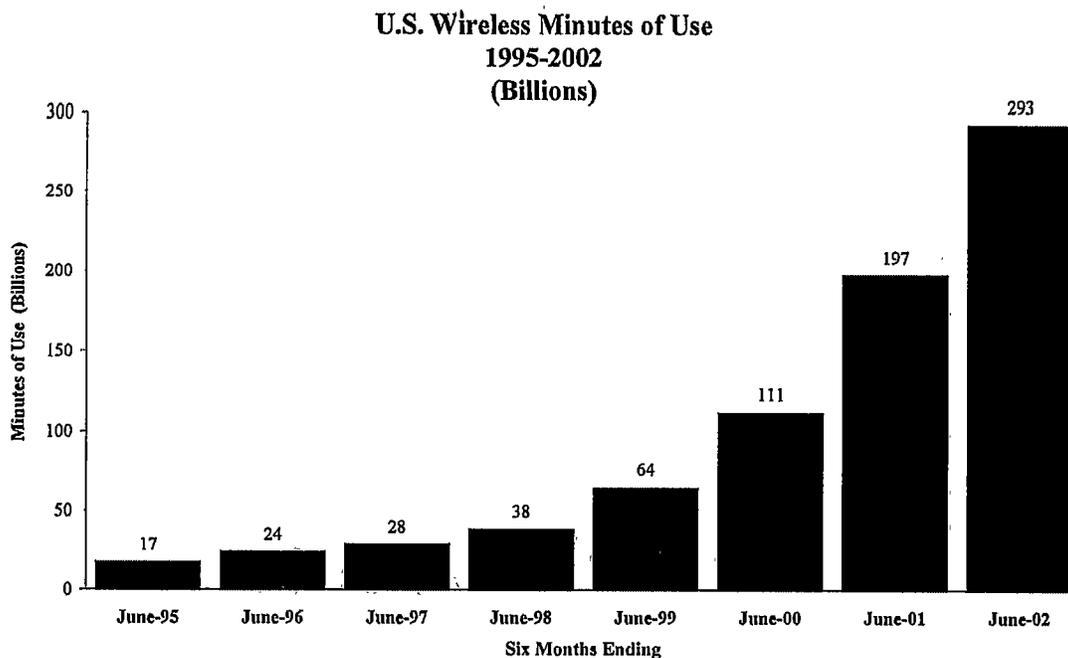
21. With shares measured on a revenue basis, the HHI for wireline services in 1995 was roughly 3,400. Revenue-based forecasts for wireline long distance shares for 2005 are not available. However, to the extent that BOCs have been successful in attracting AT&T subscribers, who typically generate below-average revenue per subscriber, then the revenue-based HHI for 2005 would be expected to be below the reported subscriber based figure.

2. Wireline long distance service faces substantial and growing competition from wireless services and new technologies

28. Standard measures of subscriber shares and concentration based on wireline subscribers overstate the concentration of long distance services and implicitly understate the increase in competition in recent years. This is because wireline long distance services now face substantial competition from wireless services, e-mail and instant messaging. These services were in their infancy in 1995, but have contributed to a substantial loss in long distance minutes carried on wireline networks in recent years. In the current environment, a unilateral attempt by an ILEC to raise prices charged for long distance would be expected to result not only in a loss of customers to rival wireline providers but also a substantial loss in minutes of long distance calling time to other service "platforms."

29. The penetration of wireless services has grown with extraordinary speed in recent years. Between June 1995 and June 2002, the number of subscribers to wireless services in the United States increased by nearly 400 percent, from 28 million to 135 million. Total wireless minutes of use increased even more dramatically over this period. Between 1995 and 2002, total wireless minutes of use increased by more than 1,600 percent. (See Figure 3.)

Figure 3:



Source: CTIA's Wireless Industry Indices, December 2002, pp. 202-203.

30. The emergence of new pricing mechanisms in wireless service plans has contributed to rapid growth in the use of wireless services for long distance calls. These include “bucket” plans (which offer a given number of minutes for a flat monthly rate) that effectively reduce the marginal costs of long distance calls to zero for many consumers. Recent analyst reports focus on substitution between wireline and wireless long distance use:

[W]ith changes in wireless pricing – more bucket plans with huge (or unlimited) bundles of night and weekend minutes, including long distance – there is growing evidence that wireless is starting to have more and more of an impact on the wireline telecom service providers.²²

Wireless MOU cannibalization has been particularly fierce in recent years as the bucket pricing is essentially giving away free long distance during the primary “consumer” hours (after 9PM and on weekends). We expect this to continue...²³

22. Merrill Lynch, “Wireless Svc: Landline Substitution Becoming More Meaningful,” April 22, 2002, p. 3.

23. Lehman Brothers, “AT&T,” November 18, 2002, p. 4.

31. The Cellular Telecommunications Industry Association (CTIA) estimates that in 2002 interstate long distance calls accounted for nearly 25 percent of wireless traffic.²⁴ This, in turn, implies that wireless service accounts for roughly 29 percent of originating interstate long distance traffic.²⁵

32. It is also widely recognized that e-mail and instant messaging provide a substitute for certain long distance calls. These forms of communication were used little if at all in 1995, but now account for billions of messages daily.

- The number of adults online, and thus with access to e-mail and instant messaging, increased from 17.5 million in 1995 to 137 million in 2002.²⁶ The number of high speed Internet lines increased from 2.8 million in December 1999 to nearly 20 million in December 2002.²⁷
- Estimates of the number of e-mail messages vary widely. According to one conservative estimate, the number of e-mail messages sent in the U.S. and Canada were expected to nearly triple between 2000 to 2003, from 6.1 billion per day to 13.7 billion per day.²⁸

24. Wireless Carrier Interstate Traffic Studies, presented in a letter from Michael Altschul of CTIA to the FCC, September 30, 2002.

25. This figure is calculated using data on total wireless minutes of use, inbound and outbound wireless calls, interstate switched access minutes, dial equipment minutes and total voice traffic reported in the CTIA's December 2002 Wireless Industry Indices survey, along with data from a CTIA survey of wireless long distance usage of five national carriers as presented in a letter from Michael Altschul of the CTIA to the FCC, September 30, 2002. The calculation assumes that the share of landline call volume that respectively terminates with (i) landline and (ii) wireless subscribers is equal to the shares of landline and wireless minutes.

26. http://cyberatlas.internet.com/big_picture/geographics/article/0,,5911_1011491,00.html (Nielsen Cyberatlas).

27. FCC, High-Speed Services for Internet Access: Status as of December 21, 2002, June 2003, Table 1

28. International Data Corporation data, eMarketer, April 23, 2001.

- In addition, instant messaging services are becoming more attractive alternatives for long distance calls. For example, Microsoft and Apple have both released test versions of their instant messaging software that incorporate both voice and video. The final Microsoft version is expected to be available free of charge, while the Apple version will be available free with Apple's new operating system.²⁹

33. The explosive growth in wireless services and e-mail has resulted in a substantial decline in wireline long distance usage in recent years, despite substantial declines in retail prices (which are discussed below). For example:

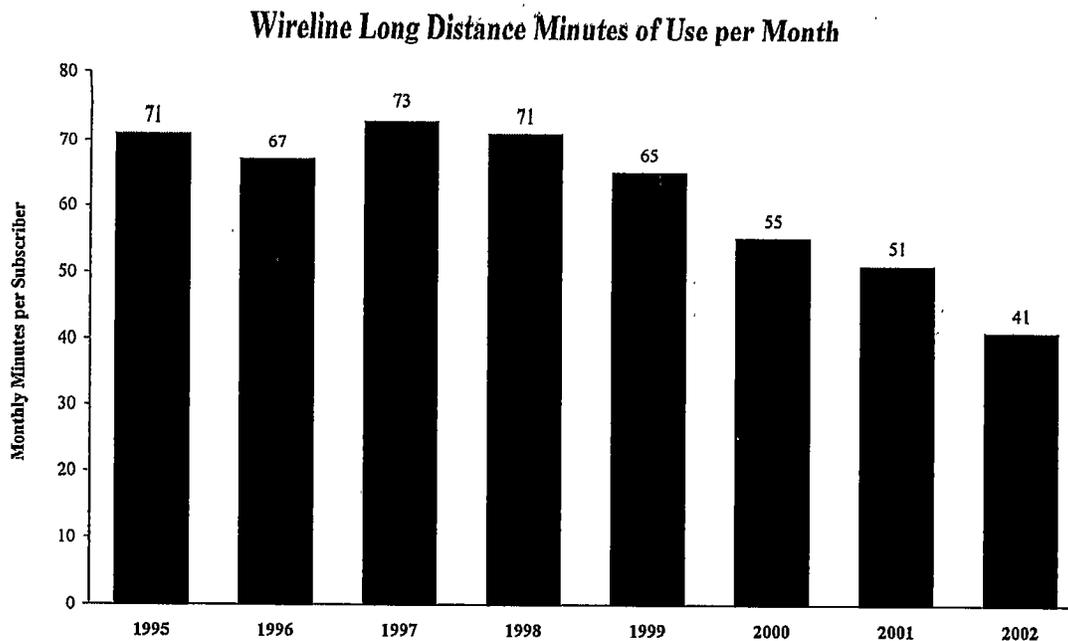
- As shown in Figure 4, FCC data indicate that the average wireline interLATA interstate usage fell from 71 minutes per month in 1995 to 41 minutes per month in 2002, a decline of 42 percent.³⁰
- As summarized in a recent Merrill Lynch analyst report, "[w]hereas two years ago an average wireline consumer LD customer made seven calls per week averaging eight minutes per call, now that same customer makes five calls a week averaging somewhat more than seven minute per call."³¹

29. David Pogue, "Video Chat Software Revisited," New York Times, June 26, 2003.

30. FCC, Statistics of the Long Distance Telecommunications Industry, May 2003, Table 20.

31. Merrill Lynch, "Wireline Services: Landline Substitution: Becoming More Meaningful," April 22, 2002, p. 2.

Figure 4:



Source: FCC's Statistics of the Long Distance Telecommunications Industry, May 2003, p. 37.
Note: Wireline long distance data reflect interLATA interstate calls.

34. Analysts estimate that the growth of wireless services and the Internet account for an even larger reduction in traffic carried by wireline long distance service providers than losses due to the entry of BOCs into the provision of long distance service.

- According to Lehman Bros., AT&T's consumer business lost roughly \$3.5 billion in revenue between 2001 and 2002. They estimate that "70% of that is due to wireless and Internet substitution (email etc.)" and that competition from BOCs accounts for "less than a third of the total."³²
- According to Merrill Lynch, "[w]ireless is evidently driving a substantial migration of LD minutes (impacting RBOC switched access minutes of use). AT&T ... indicated that consumer long distance calling volumes in 4Q02

32. Lehman Brothers, "AT&T," November 18, 2002, p. 4.

declined at a low double-digit rate driven by competition and a continued substitution.”³³

- Merrill Lynch also reports that Sprint’s “consumer LD voice volumes for wireline subscribers were down 10% YoY [year over prior year]. Sprint apportioned 75% of the impact to wireless substitution and the remaining 25% to email traffic. We estimate that AT&T’s consumer LD revenue will decline 25% YoY in 2002, with more than half of the decline coming from wireless. ... Clearly, people are not talking less, and we believe the majority of these ‘lost’ wireline minutes are in fact moving over to wireless.”³⁴

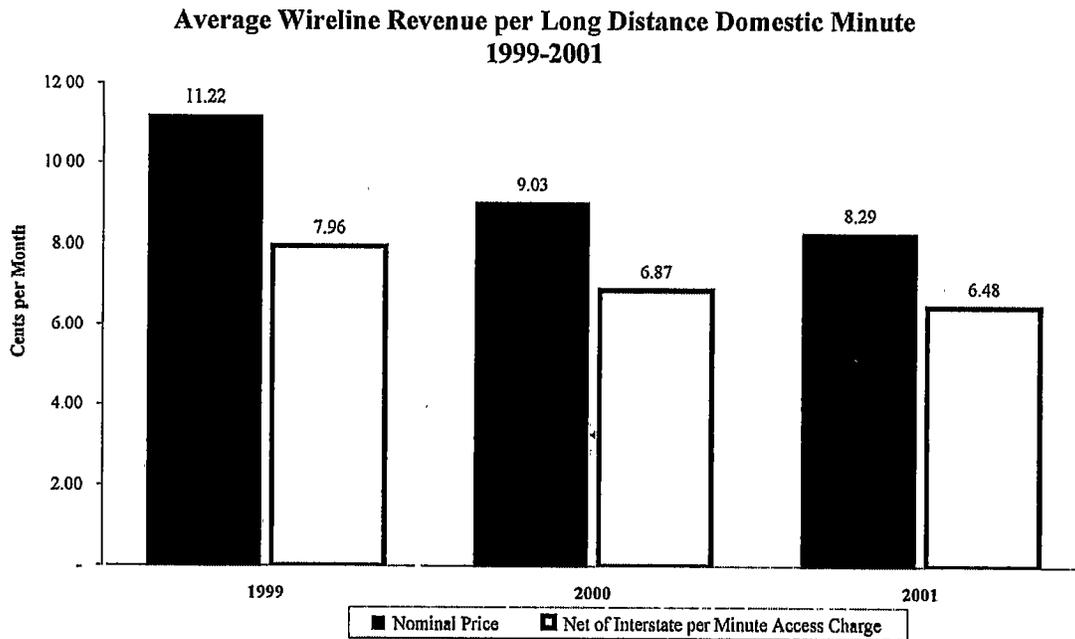
3. Long distance prices and spending have declined in recent years

35. Not surprisingly, the increases in long distance competition in recent years have resulted in declining prices. As shown in Figure 5, FCC data indicate that average revenue per minute for interstate long distance calls with wireline carriers fell from 11.2 cents per minute in 1999 to 8.3 cents per minute in 2001, the most recent data available. Net of minute-based access charges, average long distance prices fell from 8.0 cents per minute in 1999 to 6.5 cents per minute in 2001.

33. Merrill Lynch, “BellSouth Corp.”, January 27, 2003, p. 5.

34. Merrill Lynch Capital Markets, “Wireless Svc: Landline Substitution: Becoming More Meaningful.” April 22, 2002, p. 3.

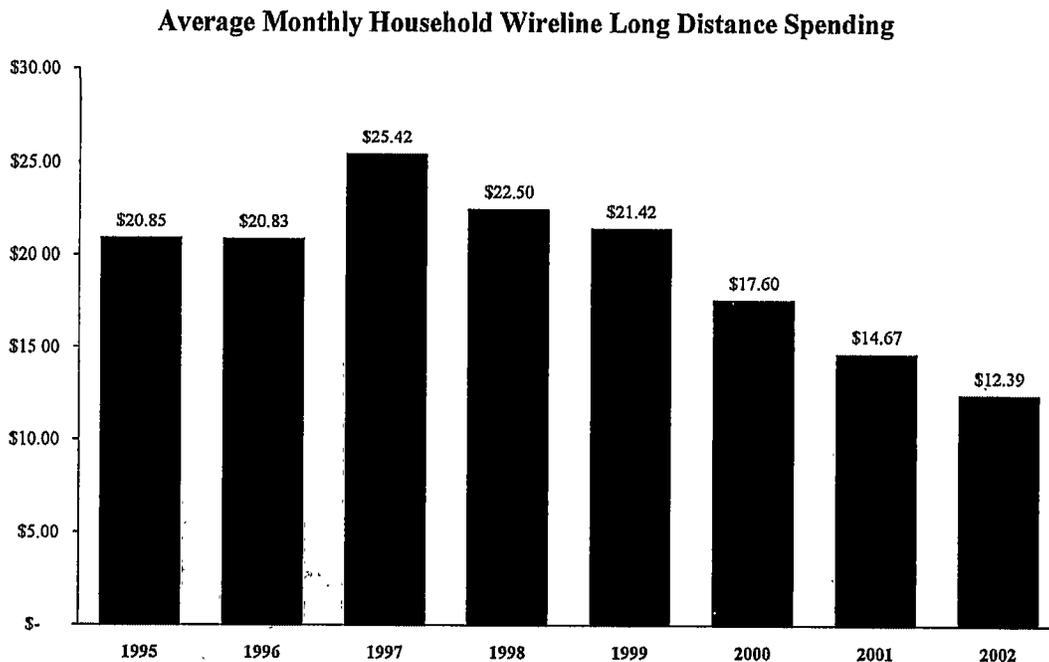
Figure 5:



Source: FCC's Statistics of the Long Distance Telecommunications Industry, May 2003, Table 5;
Trends in Telephone Service, May 2002, Table 1.2.

36. The combination of the decline in price and the decline in long distance usage described above, has resulted in a large decline in consumer long distance spending in recent years. As shown in Figure 6, average monthly household spending on long distance carriers fell from \$20.85 in 1995 to \$12.39, a decline of nearly 40 percent. In inflation-adjusted terms, the decline is even larger, approximately 50 percent.

Figure 6:



Source: FCC, Statistics of the Long Distance Telecommunications Industry, May 2003, Table 13.

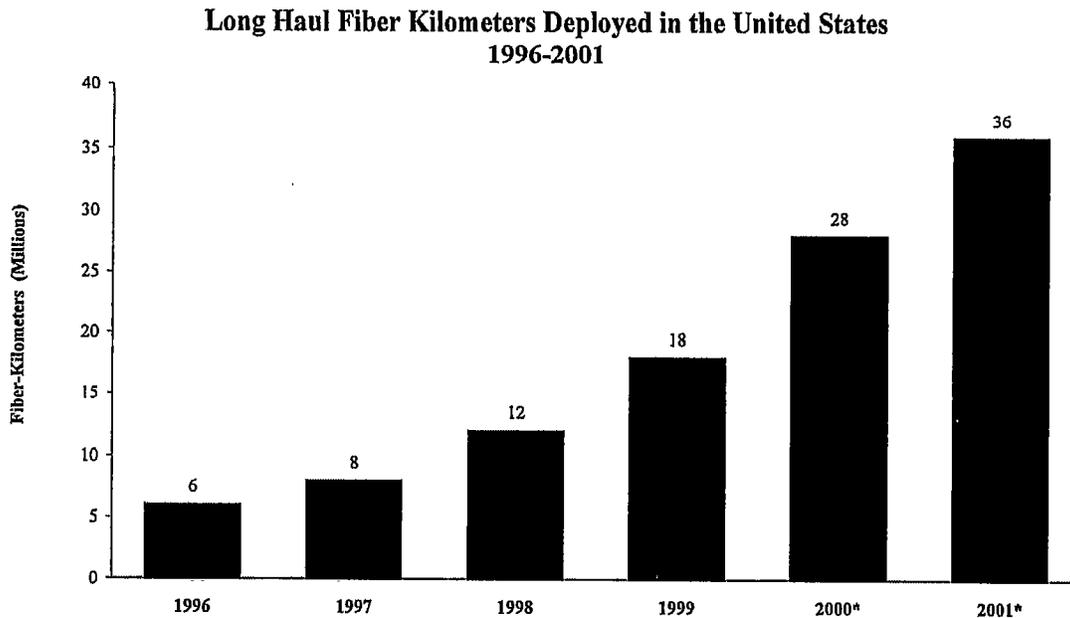
4. There has been a massive increase in transmission capacity in recent years.

37. The FCC's 1995 AT&T Non-Dominance Order stressed that there is capacity available for industry expansion and that long distance carriers have the ability to do so.³⁵ Since that time, there have been massive increases in fiber optic capacity throughout the United States as several new, national fiber optic networks have been deployed.

38. According to 1999 estimates, the number of fiber-kilometers of fiber optic cable deployed in the United States was expected to increase from 5.9 million in 1996 to 35.9 million in 2001. (See Figure 7.) This includes new networks deployed by Qwest, Level 3, Williams, IXC, and a variety of others as well as expansion by existing network providers. As is widely recognized, this massive expansion produced a "glut" that resulted in a number of bankruptcies. Nonetheless, this fiber capacity remains in place leaving existing carriers and entrants the ability to rapidly expand.

35. AT&T Non-Dominance Order, ¶58.

Figure 7:



Source: KMI Corp., *Fiber-optic Networks of Long Distance Carriers in North America: Market Developments and Forecast*, November 1999, p. A-1.

* Estimates

39. Even the growth in fiber deployment implicitly understates the increase in telecommunications capacity due to the continuing development of electronics capable of carrying larger amounts of information in a given optical fiber. For example, in the FCC's 1998 MCI WorldCom Order, the FCC noted that new network technologies, such as Dense Wave Division Multiplexing (DWDM) alone were expected to allow a 100-fold increase in U.S. fiber backbone capacity between 1997 and 2000.³⁶ Since that time, new network technologies permit even greater increases in capacity. In 1998, Ciena's DWDM equipment transmitted up to 240 Gb/s.³⁷ The current version of Ciena's DWDM product transmits up to 1.6 Tb/s, more than a six-fold increase.³⁸

36. FCC, MCI WorldCom Order, FCC 98-225, September 14, 1998, ¶64.

37. Ciena Press Release, "Sprint Increases Network Capacity, Performance with Deployment of Ciena's Scaleable 40-Channel Multiwave 4000," March 16, 1998.

38. Ciena CoreStream Dense Wavelength Division Multiplexing System, <http://www.ciena.com/products/transport/longhaul/corestream/index.asp>.

40. In discussing the increase in the capacity of new telecommunications equipment, the FCC concluded in its 1998 MCI WorldCom order that “[a]s a result, existing carriers can expand capacity to constrain a unilateral exercise of market power by any other carrier, and new carriers likely will be able to constrain any coordinated exercise of market power by the incumbents.”³⁹

5. Long term industry trends toward increased competition are expected to continue

41. While the long distance industry continues to respond to the entry of BOCs and the growth of intermodal competition from wireless services and e-mail, additional changes – such as Voice over Internet Protocol (VoIP) and bundling of local and long distance services -- are starting to bring yet more competition to the industry.

42. For example, new services using “Voice Over Internet Protocol” (VoIP) technology have been introduced. These services promise to deliver another alternative to the wireline long distance (and local) networks by using the Internet to carry voice messages. FCC Chairman Powell noted that “... 2002 saw the introduction of reliable Internet telephony services as companies such as Vonage are providing an alternative to analog wired telephony over a broadband connection.”⁴⁰

43. VoIP services are also expected to speed deployment of cable telephony, resulting in further intermodal competition for wireline long distance suppliers. Cox, Cablevision, Time Warner and Comcast have all begun trials of VoIP based telephone service.⁴¹ Deutsche Bank highlights the VoIP’s potential significance in promoting cable telephony:

39. FCC, MCI WorldCom Order, ¶64.

40. Written Statement of Michael Powell before the Committee on Commerce, Science, and Transportation, United States Senate, January 14, 2003.

41. Morgan Stanley, “Industry Report, Wireline Telecom Services – Trend Tracker: Bottom Line Better,” May 23, 2003, p. 16.

We maintain our view that cable telephony, as well as a more broadly-defined "triple-play" bundle, represents the greatest longer-term threat to wireline operators. ... Although the [cable] industry has waited on VoIP for a good part of the last decade, it appears highly likely that a competitive product could finally emerge sometime in late 2003 or early 2004. Thus, in 2005, the operating incentive could easily catch-up with technology, providing cable operators with both the opportunity and means to become a force in the telecom industry.⁴²

44. As this example suggests, there is every indication that the dramatic and pro-competitive changes in industry conditions observed since the FCC declared AT&T to be a non-dominant carrier in 1995 are continuing. Morgan Stanley, for example, recently concluded that "[w]e expect the long distance industry to continue its free-fall as the twin forces of excessive competition and lack of demand continue indefinitely."⁴³

IV. EXPIRATION OF STRUCTURAL SEPARATION RULES WOULD NOT ENABLE ILECS TO HARM COMPETITION BY MANIPULATING ACCESS TO THEIR LOCAL NETWORKS

45. As noted above, the FNPRM asks for comments on various theories which have been raised by ILECs' long distance rivals, who suggest that expiration of structural separation requirements would enable ILECs to harm competition by (i) engaging in non-price discrimination in providing local network access to rival long distance suppliers;⁴⁴ (ii) engaging in a "price squeeze" designed to drive their rival long distance carriers from the market; and (iii) shifting costs from their long distance subsidiaries to local business units.⁴⁵ We find that there is

42. Deutsche Bank, "Wireline – Mid Year Review: Last Man Standing," May 27, 2003, p.27.

43. Morgan Stanley, "Wireline Telecom Services – Trend Tracker: Bottom Line Better," May 23, 2003, p. 7.

44. "We also seek comment on whether allowing BOCs and independent LECs to provide interexchange service on an integrated basis will diminish the ability of regulators and interexchange competitors to detect such discrimination." FNPRM, ¶31.

45. "We seek comment on the incentives and abilities of these carriers to misallocate their costs, discriminate, and engage in predatory price squeezes to such an extent that they may increase their market share and attain market power in the interstate and international interexchange markets. ... We ask whether the carriers' incentives and abilities increase if they provide interstate and international interexchange services on an integrated basis." FNPRM, ¶29.