

1 terminate calls on the BOCs' *local* networks. Prior to the break-up, the Bell System local  
2 companies provided their long distance affiliate with a far superior quality of access to their  
3 local networks and customers than was being offered to the nonaffiliated "Other Common  
4 Carriers" ("OCCs")<sup>53</sup> For example, calls placed by BOC customers were in all cases  
5 automatically routed to their long distance affiliate whenever the customer dialed a call on a  
6 "1+" basis. OCC customers were forced to dial lengthy "access codes" and manually enter  
7 their billing account information. Additionally, the interconnection arrangements being  
8 provided by the BOCs to their long distance affiliate were far superior in a number of other  
9 qualitative respects, for example, BOC local and long distance billing was handled on an  
10 entirely integrated basis, and the BOC billing system was provided with "answer supervision"  
11 by the terminating carrier indicating when the called party answered the call as well as when  
12 the called party terminated the conversation by hanging up the phone. The BOC-affiliated  
13 long distance carrier was thus able to provide accurate long distance billing to its customers,  
14 whereas OCCs, whose interconnection arrangements with the BOCs typically did not include  
15 "answer supervision," would often bill for calls that were not answered or fail to bill for short  
16 calls that were

17

18 33. The MFJ and subsequent implementing regulations focused heavily upon the so-  
19 called "equal access" requirement, a set of interconnection arrangements that was designed to  
20 end disparity in BOC/OCC traffic exchanges. Although the bulk of the "equal access" issues  
21 were resolved by the end of the 1980s, several sources of disparate treatment persisted until

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22 53. The term "Other Common Carriers" ("OCCs") was used to refer to interexchange  
23 carriers other than AT&T

1 as late as 1999<sup>54</sup> In establishing specific rules for implementation of the Section 272(b)(1)  
2 “operate independently” requirement, the Commission has focused particularly upon the  
3 “equal access” concerns, directing that all operating equipment and facilities be separately  
4 owned, and that installation and maintenance services be provided separately to the BOC and  
5 its affiliate. The FCC has applied section 272(b)(1) specifically to forestall BOC affiliate  
6 advantages such as those formerly enjoyed by the integrated AT&T in terms of access:

7  
8 We conclude that a BOC may not discriminate in favor of its section 272  
9 affiliate by: 1) providing exchange access services to competing interLATA  
10 service providers at a higher rate than the rate offered to its section 272 affiliate;  
11 2) providing a lower quality service to competing interLATA service providers  
12 than the service it provides to its section 272 affiliate at a given price; 3) giving  
13 preference to its affiliate’s equipment in the procurement process; or 4) failing to  
14 provide advance information about network changes to its competitors.<sup>55</sup>  
15

16 As I shall discuss in more detail below (at para 58), it now appears that at least one BOC —  
17 BellSouth — has recently attempted to flaunt this nondiscrimination requirement as well,  
18 offering more favorable rates for switched access to its long distance affiliate than are  
19 available to other IXCs

20

21 34 Prior to “equal access,” BOCs had the ability to — and did — preemptively direct  
22 their *local service customers’ business* to their long distance affiliate *each time the local*  
23 *customer dialed an interLATA or intraLATA toll call* and by so doing prevented competing  
24 carriers from providing service to — “addressing” — the BOCs’ customers. This enormous

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25 54 Although the BOCs were required by the MFJ and the FCC to route *interLATA* calls to  
26 the interexchange carrier selected by the customer as the “Presubscribed Interexchange  
27 Carrier”) (“PIC”), BOCs were permitted to route 1+ *intraLATA* calls to their own networks  
28 until as recently as 1999 — three years following enactment of the 1996 federal legislation.  
29 47 U.S.C. § 271(e)(2)(B)

30 55 *Non-Accounting Safeguards Order*, at 21914

1 competitive advantage was partially resolved via a two-pronged policy framework that  
2 coupled a *structural* remedy with active regulatory initiative and involvement. Specifically,  
3 by structurally separating (in fact, divesting) the BOCs from their long distance affiliate, the  
4 BOCs' *incentive to discriminate* was effectively eliminated, since such discrimination would  
5 no longer afford the BOCs with any financial or market advantage. Then, by imposing an  
6 affirmative "equal access" requirement, the BOCs were forced to interconnect with all long  
7 distance carriers -- including their former affiliate -- on the same or equivalent qualitative  
8 and financial terms.

9  
10 35 It is noteworthy that both the structural and regulatory initiatives launched by the  
11 MFJ were confined strictly to the *interLATA* market; BOCs were not required to separate their  
12 local and *intraLATA* toll services, nor were they required to provide the same level of "equal  
13 access" to competing nonaffiliated *intraLATA* toll carriers.<sup>56</sup> As a consequence, the BOCs  
14 did not confront the same "indifference" with respect to their end-user customers' choice of  
15 *intraLATA* carrier as they did with respect to *interLATA* services, and continued to  
16 preemptively route customer's *intraLATA* calls to the BOCs own *intraLATA* service.  
17 Without a corresponding *intraLATA* "equal access" requirement, the BOCs not surprisingly  
18 continued to overwhelmingly dominate the *intraLATA* long distance market, and were able to  
19 maintain that largely unchallenged position until the "equal access" requirement was

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20 56 The industry model envisioned at that time by framers of the MFJ allocated  
21 *interLATA* services to IXCs, while placing local and *intraLATA* toll and access services with  
22 the divested BOCs. Since IXCs were not expected to compete for *intraLATA* toll services,  
23 the lack of an "equal access" requirement with respect to this segment did not receive very  
24 much attention. The 1996 *Act* replaced the MFJ model with one in which competition would  
25 be permitted *and accommodated* at all levels, which required that the "equal access" and  
26 associated nondiscrimination concepts become applicable for all local and *intraLATA* services  
27 as well as for the *interLATA* segment that had been addressed in the MFJ.

1 ultimately extended to this segment, which did not occur until about 1999.<sup>57</sup> Until that date,  
2 the BOCs were able to — and did — leverage their local service monopoly to diminish  
3 competition in, and maintain their dominance of, the adjacent intraLATA toll market.

4  
5 36 BOC entry into the in-region *interLATA* long distance market creates precisely the  
6 same potential for anticompetitive conduct and market advantage as prevailed in the  
7 intraLATA market during the period between the 1984 Bell System break-up and the 1999  
8 completion of intraLATA equal access. While the matter of call-by-call preemption (the 1+  
9 dialing advantage) has been explicitly addressed through first the interLATA and then the  
10 intraLATA “equal access” requirement, the BOCs still maintain and benefit competitively  
11 from yet another — and fully comparable — form of preemptive access to their legacy local  
12 service customers — the “*inbound marketing channel*”

13  
14 37. There is a clear and unmistakable analogy between the predivestiture/pre-equal  
15 access “1+ dialing” advantage and the post-271 “inbound marketing channel” advantage that  
16 the BOCs presently enjoy. Most customers do not have a real choice as to their local carrier,  
17 and customers overwhelmingly call the incumbent LEC first.<sup>58</sup> Most of these callers are  
18 likely not contacting the BOC for the purpose of ordering — or even inquiring about — the

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19 57 47 U.S.C. § 271(e)(2)(B) provides that “a state may not require a Bell operating  
20 company to implement intraLATA toll dialing parity in that State before a Bell operating  
21 company has been granted authority under this to provide interLATA services originating in  
22 that State or before 3 years after the date of enactment of the Telecommunications Act of  
23 1996, whichever is earlier.”

24 58 Indeed, a *Mover's Guide* distributed by the United States Postal Service to residential  
25 customers when they file a Change of Address notice advises them to “call your local phone  
26 company a month before you move” and then proceeds to list specifically the operating areas  
27 and phone numbers for BellSouth, Qwest and Verizon. See Attachment 4 to this Declaration.

1 BOC's long distance services where available. Most are calling to order new or additional  
2 local service, to change their existing service, report a service problem, inquire about a billing  
3 issue, order optional features, to move their service to a new location, or to obtain infor-  
4 mation about new local services that might become available, such as ADSL. Each of these  
5 inbound contacts provides the BOC with an opportunity to sell long distance service. And  
6 although initiated by the customer for a different purpose, each of these in-bound calls is, in  
7 the end, initiated by the caller with the intention of dealing in some manner with telephone  
8 service issues. As long as the BOCs maintain their position of overwhelming market  
9 dominance in the local market — which they do — customers will have a strong propensity  
10 to contact “the phone company” — the BOC or other incumbent LEC — for local phone  
11 service, and this propensity is particularly evident in the residential and small business  
12 segments.

13

14 38. Once the BOCs have been contacted by the customer regarding local service, they  
15 are permitted to preemptively suggest to the consumer that the BOC affiliate handle all of the  
16 customer's interLATA calls. A customer's selection of a carrier other than the BOC affiliate  
17 requires that the customer take additional, affirmative steps to make such a choice, and most  
18 likely, choose to initiate another phone call to the selected interLATA carrier in order to  
19 choose the appropriate discount calling plan. Just as in the intraLATA market, placing these  
20 additional burdens upon consumers who might otherwise elect to do business with a non-BOC  
21 long distance carrier will discourage customer choice and thereby place competing IXCs at a  
22 significant disadvantage vis-a-vis the BOC affiliate. The extent of this disadvantage can be  
23 illustrated by the fact that, in the states in which the BOCs have obtained in-region entry  
24 authority, BOC affiliates have amassed long distance market share at an unprecedented rate.  
25 The California PUC ALJ, speaking to this very point, observed that:

26

1 We find that Pacific's proposed joint marketing plans, detailed above in relation  
2 to § 709 2(c)(3), also pose a substantial possibility of harm to the intrastate long  
3 distance telephone market. The significant advantage afforded Pacific's long  
4 distance affiliate by Pacific's ability to market its affiliate's service to several  
5 million incoming customer service calls per year from its existing local service  
6 customers will unquestionably affect the other interexchange carriers. No other  
7 interLATA competitor in California has any similar massive opportunity to  
8 address incoming calls from potential interLATA customers. PBLD's potentially  
9 swift dominance of the intrastate interexchange telephone market could detri-  
10 mentally impact competition in that sector.<sup>59</sup>

11

12 39 Actual BOC market penetration results as reported by BOCs in states where in-  
13 region interLATA entry has been authorized demonstrate the dramatic and unprecedented  
14 success that the BOCs have achieved in capturing market share. After approximately twelve  
15 months following its receipt of Section 271 authority in New York, Verizon Long Distance  
16 reported a New York residential market share of 20%.<sup>60</sup> In addition, Verizon's New York  
17 long distance market penetration continued to grow at an impressive rate beyond the first  
18 year. After 21 months of providing long distance service in New York, Verizon reported a  
19 New York long distance market share of 31.7%, and at the end of 2001, after two full years  
20 of 271 authority, Verizon reported a market share of 34.2%.<sup>61</sup>

21

22 40 Verizon's experience in New York is not anomalous. Nine months after receiving  
23 271 authority in Massachusetts, Verizon reported a long distance market share of more than

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24 <sup>59</sup> *California PUC Draft 271 Decision*, at 247

25 <sup>60</sup> See Verizon Press Release, "Verizon Communications Post Strong Results for Fourth  
26 Quarter and 2000," February 1, 2001

27 <sup>61</sup> Verizon Press Release, "Verizon Communications Reports Solid 3Q Earnings and  
28 Provides Outlook For Remainder of 2001," October 30, 2001, Verizon Press Release,  
29 "Verizon Communications Reports Solid Results For Fourth Quarter, Provides Outlook for  
30 2002," January 31, 2002

1 20%, and indicated that sales results for Pennsylvania, where Verizon began marketing long  
2 distance services in late October 2001, were in line with early success rates in other Verizon  
3 states.<sup>62</sup> In Texas, where SBC received interLATA authority in June of 2000, SBC reported  
4 that after less than nine months its long distance affiliate, SBCS, had acquired 2.1-million of  
5 SWBT's 10-million local customers, representing a 21% share of the long distance market in  
6 the state.<sup>63</sup> SBC subsequently stopped releasing long distance market share figures on a  
7 state-by-state basis, making further state-level analyses no longer possible.

8

9 41 The economic value of this preemption advantage enjoyed by BOC affiliates  
10 acquiring interLATA customers is graphically illustrated when one considers the speed and  
11 ability of OCCs to gain interLATA market share without similar preemptive advantages. The  
12 transition to interLATA equal access began in 1985 and was substantially complete by the  
13 end of 1988. The 1985 beginning of the transition to equal access can be thought of as the  
14 date at which the elimination of economic barriers to interLATA long distance entry began.  
15 That event is then analogous to the BOCs' initial satisfaction of the 14-point checklist which,  
16 presumably, eliminated the economic barriers to entry into the local market. But the  
17 consequences of these otherwise comparable policy initiatives have been dramatically  
18 different: By the end of the fifth year (*i.e.*, by the end of 1990) following the commencement  
19 of interLATA equal access, all of the non-AT&T IXCs *combined* had collectively acquired  
20 22 92% of presubscribed lines nationwide,<sup>64</sup> even with the aid of such "jump-start" market  
21 development measures as "equal access balloting" and automatic assignment of nonresponding

22 62 *Id.*

23 63 *SBC Investor Briefing*, April 23, 2001, at 7

24 64. Federal Communications Commission, Wireline Competition Bureau, Industry Analysis  
25 Division, *Long Distance Market Shares, Fourth Quarter 1998*, March, 1999, ("*Long Distance*  
26 *Market Share Report*"), Table 2.1

1 subscribers to a non-AT&T carrier. Of course, what the OCCs did not have, but which the  
2 BOCs do, is the massive legacy customer base to exploit. It is thus not surprising that in just  
3 two years following its entry into the New York interLATA market, Verizon was able to  
4 capture 34.2% of its New York in-franchise local service customers, a level of market share  
5 that *no single OCC has ever reached*<sup>65</sup> and that took *all of the OCCs combined* some 10  
6 years (following the 1985 commencement of equal access) to accomplish.<sup>66</sup>

7  
8 42. Compounding the formidable competitive advantage that is available uniquely to  
9 BOCs through their exploitation of the “inbound marketing channel” is the fact that the  
10 “price” that the BOC long distance affiliate “pays” to the BOC for such joint marketing  
11 “services” is woefully short of fair market value and thus constitutes a *de facto* cross-subsidy  
12 flowing from the BOC’s regulated ILEC services to the BOC’s competitive long distance  
13 services. As the California PUC ALJ noted, maintenance of separate affiliate requirements is  
14 *critical* to the CPUC’s ability to detect and ultimately remedy such practices.

15  
16 Pac-West/WA’s costing discussion and comparison regarding the proposed joint  
17 marketing plan clearly demonstrates cross-subsidization, and we find it very  
18 troubling. We trust that Pacific will very carefully re-examine the cost elements  
19 of its proposed joint marketing plan to ensure full compliance with our rules.  
20 Moreover, we reaffirm the auditing requirements that we designed in  
21 D 99-02-013 for Pacific and PBLD’s joint marketing arrangements. Our  
22 confidence in non-structural safeguards has waned significantly over the last few  
23 years. Thus, if our required audits uncover cost allocation improprieties in the  
24 final joint marketing agreements, we will not hesitate to take the strongest  
25 action.

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26 65 According to the most recent (2001) FCC IXC market share report, the largest non-  
27 AT&T IXC, MCI Worldcom, had a year-end 1999 residential market share of 16%, well  
28 below Verizon’s two-year New York share of 34.2%. FCC Industry Analysis and Technology  
29 Division, *Statistics of the Long Distance Telephone Industry*, January 2001 (Data as of 1999),  
30 Table 24.

31 66 *Long Distance Market Share Report*, at Table 2.2.

1           The record before us simply does not support the finding that there is no  
2           improper cross-subsidization anywhere within Pacific's proposal to provide long  
3           distance telephone service within California. Rather, the record includes  
4           documents that purport to show compliant costing allocations as well as  
5           documents that purport to show inappropriate allocations and underlying  
6           methodology. As of this date, the mandated audits have not yet been performed.  
7           However, we do find that our requirements for separate accounting records and  
8           for the examination of the cost allocation methodology for the provision of  
9           intrastate interexchange telecommunications service, pursuant to our affiliate  
10          transaction and cost allocation rules and O.P. 8 and 18 of D 99-02-013, will be  
11          integral in preventing, identifying and eliminating improper cross-  
12          subsidization.<sup>67</sup>

13

14          43 In view of the strong parallels between OCC entry in the 1980s and BOC entry  
15          today, I believe that the *results* of the earlier policy paradigm offer a useful and reasonable  
16          standard against which the current policy initiatives relative to BOC entry can be evaluated.  
17          That is, but for the BOCs' ability to exploit their inbound marketing channel, there is no *a*  
18          *priori* reason to expect their rate of market share growth to differ materially from that of the  
19          OCCs in the initial years following "equal access." Conversely, evidence of substantially  
20          greater BOC long distance market share growth serves to confirm the enormous value that  
21          Verizon and other BOCs obtain solely by virtue of their status as dominant local exchange  
22          carriers.

23

24          44 The extraordinary marketing advantage uniquely available to BOCs stemming from  
25          their use of the "inbound channel" has not been overlooked by Wall Street. As a February 8,  
26          2001 Credit Suisse First Boston ("CSFB") report commented

27

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28          67 *California PUC Draft 271 Decision*, at 242; footnotes omitted

1           We've been watching this industry for almost 20 years and we have never seen  
2           consumer share gained at the rate of VZ in NY and SBC in TX (the former 20%  
3           share in 12 mos and the latter 18% share in 6 months)<sup>68</sup>  
4

5           When a BOC obtains Section 271 authority, it gets not simply the right to enter yet another  
6           isolated line of business, but the right to *integrate* local and long distance service into a single  
7           package, to make the two services essentially indistinguishable from the consumer's  
8           perspective, and to leverage its dominance of the local market to similarly come to dominate  
9           the long distance market as well.

10  
11           45 It is abundantly apparent that the *entire foundation* of the BOCs' long distance entry  
12           strategy rests upon their ability to exploit the inbound marketing channel and their legacy  
13           relationships with existing BOC local service customers. *De facto*, and ultimately *de jure*,  
14           integration of the BOC local and long distance services regardless of the requirements of  
15           Section 272 is a critical element of this strategy. Lest there be any doubt about this, the  
16           Commission should recall that BOCs have been permitted into the *out-of-region* long distance  
17           market since the enactment of the 1996 *Act* (i.e., February 8, 1996). At that time, *BOCs were*  
18           *permitted to provide interLATA long distance service in all out-of-region states*<sup>69</sup>. However,  
19           *none of the RBOCs availed themselves of this opportunity* except with respect to certain out-  
20           of-region services, such as Calling Card services, that could be marketed to their *in-region*  
21           local service customers. Moreover, rather than compete out-of-region, both SBC and Bell  
22           Atlantic chose instead to *acquire* via merger out-of-region BOCs, expressly foregoing their

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23           68. "VZ Analyst Mtg Provides Comprehensive '01 Outlook," Credit Suisse First Boston,  
24           09 47am EST, 8-Feb-01 ("*Credit Suisse First Boston Report*")

25           69 Section 271(b)(2) provides that "A Bell operating company, or any affiliate of that  
26           Bell operating company, may provide interLATA services originating outside its in-region  
27           States after the date of enactment of the Telecommunications Act of 1996 . . ."

1 opportunity for *immediate* long distance entry in those states but without the opportunity to  
2 leverage the ILEC subscriber base, for eventual long distance entry following Section 271  
3 approval when they could pursue the fully integrated joint marketing strategy  
4

5 46 That SBC's marketing plans with respect to its long distance service are intimately  
6 linked to its legacy local service customer base is further confirmed by the fact that SBC's  
7 policy in its Section 271 states – Texas, Oklahoma, Kansas, Arkansas and Missouri — is to  
8 limit the availability of SBC long distance service to SBC local service customers only,<sup>70</sup>  
9 i.e., to not even offer or provide long distance service to customers of other ILECs or of  
10 CLECs. Thus, not only has SBC maintained its policy of not pursuing any out-of-region long  
11 distance entry, it does not even offer long distance service either to CLEC customers or to  
12 independent ILEC customers *within the states in which SBC has received Section 271*  
13 *authority*. Such revealed conduct compels the inescapable conclusion that the opportunity to  
14 engage in these practices appears to be the sole driver of SBC's interest in the long distance  
15 business. Credit Suisse First Boston makes the point profoundly clear in its comparison of  
16 (pre-merger) GTE's approach to selling long distance services through a separate CLEC  
17 affiliate vs. Verizon's and SBC's ability to offer long distance services directly to their ILEC  
18 customers

19  
20 In stark contrast to Verizon's huge and quick 20% consumer LD share gains in  
21 NY State, LD subscribership was flat in the GTE franchise areas in '00 despite  
22 GTE's benefitting from similar pre-established branding and billing relationships.  
23 The difference is that GTE has not leveraged the inbound channel and also had  
24 been running its LD effort through its "CLEC", in effect forcing customers to  
25 switch to the GTE CLEC both their local service from GTE's ILEC and their  
26 LD service from another LD customer. Not very successful if you ask us and

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27 70 See Attachment 5 to this Declaration. This is a print-out of the response I received  
28 from the SBC website when I attempted to order SBC long distance service using a  
29 hypothetical telephone number in a Texas exchange not served by SWBT.

1           certainly worthy of change given the empirical evidence that VZ's and SBC's  
2           use of the inbound channel and separate LD sub (but not bundled with local)  
3           have been extraordinarily successful<sup>71</sup>

4  
5           47 As the Credit Suisse First Boston report observes, this preemptive use of the  
6 "inbound channel" by both Verizon and SBC to "sell" their long distance service to *new* local  
7 service customers has been the principal explanation for their extraordinary success in  
8 acquiring customers in the first year in which they have been permitted into the long distance  
9 business. Indeed, SBC was sufficiently satisfied with its early market performance in Texas  
10 that after only seven months the company *increased* its interstate long distance rates by over  
11 10%. As reported in the *Ft Worth Star-Telegram*, February 2, 2001

12  
13           Southwestern Bell announced it was raising the interstate rate on its flagship plan  
14 from 9 cents a minute to 10 cents a minute for new customers seven months after  
15 entering the long-distance market in Texas. Current subscribers will see no change  
16 in their domestic U.S. calling charges, said Shawn Ramsey, a San Antonio-based  
17 spokeswoman for Southwestern Bell, a unit of SBC Communications.

18  
19           Ramsey defended the increase, which doesn't require approval by the state's Public  
20 Utility Board, by saying the plan is superior to many offered by the major long-  
21 distance services. "We beat the pants off of them," she said. "We've got great rates  
22 any way you slice or dice it." Asked if the higher rate reflects a need to boost  
23 profits, she said "We've been in the market about eight months now. We've learned  
24 a lot and made a number of changes that reflect what we've seen. And we've  
25 changed our plan accordingly."<sup>72</sup>

26  
27           48 Indeed, at least with respect to these types of sales at the time of the initial local  
28 service contact, the BOC need spend little if any resources actually advertising or otherwise  
29 marketing its long distance services. The inbound caller has already made the contact with

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30           71 *Credit Suisse First Boston Report*

31           72 "SW Bell raises interstate rate, current subscribers unaffected, PUC approval not  
32 needed." *Ft Worth Star-Telegram*, February 2, 2001

1 "the phone company" for basic telephone service and, unless that customer is a student of  
2 telecommunications industrial organization and regulation, he or she is as likely as not to  
3 accept the BOC's "recommendation" as the only and obvious choice

4  
5 **A recent BOC-commissioned "study" claims that consumers will benefit from lower**  
6 **BOC long distance prices because BOCs with 271 authority are "profit-maximizing"**  
7 **across their access and retail toll services combined; if so, then the BOCs would be in**  
8 **violation both of access charge imputation rules as well as Section 272 separate affiliate**  
9 **requirements.**

10

11 49 A recently released empirical study of Verizon and SBC pricing following their  
12 receipt of 271 authority in New York and Texas, respectively, suggests that in both instances  
13 the BOC ILEC entity and the Section 272 structurally separated long distance affiliate are not  
14 maintaining the "arm's length" relationship that is required by Section 272(b)(5) and, more  
15 generally, are operating vis-a-vis one another *as if the Section 272(a) and (b) structural*  
16 *separation requirements did not exist*. The study, "Does Bell Company Entry into Long-  
17 Distance Telecommunications Benefit Consumers?" by Jerry A. Hausman, Gregory K.  
18 Leonard, and J. Gregory Sidak,<sup>73</sup> ("HLS") claims to have found "a statistically significant  
19 decrease of 8 to 12 percent in the average bill in states where BOC entry occurred as  
20 compared to the states without BOC entry."<sup>74</sup> I have examined the so-called empirical basis  
21 for the authors' various contentions and have identified a number of serious, indeed, fatal

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22 73 Jerry A. Hausman, Gregory K. Leonard and J. Gregory Sidak, "The Consumer-Welfare  
23 Benefits from Bell Company Entry into Long-Distance Telecommunications: Empirical  
24 Evidence from New York and Texas" ("Hausman/Leonard/Sidak" or "HLS"), unpublished  
25 study, dated May 2002

26 74 *Id.*, at 2

1 deficiencies in their analysis.<sup>75</sup> Nevertheless, the study, which was commissioned by Qwest  
2 in support of its Section 271 applications,<sup>76</sup> advances a theoretical basis for the empirical  
3 results they claim to have obtained. If the authors' empirical findings and claims are  
4 accurate, however, the theoretical "double marginalization" explanation that they offer for this  
5 outcome would indicate that both Verizon in New York and SBC in Texas are in violation of  
6 the separate affiliate requirement.

7

8 50 Hausman *et al.* explain "double marginalization" as follows:

9

10 Double marginalization occurs when two companies have a vertical supplier-  
11 customer relationship. The upstream company sets its margin to maximize its  
12 profits individually, while the downstream company does the same. If the  
13 upstream company begins to offer the downstream product also, it generally will  
14 set the final price of the downstream product to maximize its profits jointly.  
15 The company offering the combined product will often find that it can increase  
16 its profits by lowering the price of the final product below the combined price  
17 that would obtain in the previous situation.

18

19 Suppose that a BOC's incremental margin on the provision of network access is  
20 \$0.02 per minute, while the IXC's incremental margin on residential long-  
21 distance service is \$0.04 per minute. The BOC will find it to be profit  
22 maximizing to lower the total margin from \$0.06 per minute because it earns  
23 both margins, rather than only a single margin (\$0.02 for access + \$0.04 for  
24 long-distance = \$0.06 total margin). The BOC would also be using two sets of

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25 75 Selwyn, Lee L., "BOC Long Distance Entry Does Not Benefit Consumers," presented  
26 at the Department of Justice Telecom Workshop, "*The Drivers and Significance of Compe-*  
27 *tition in Local Telecommunications: Empirical Evidence*," Washington, DC, July 23, 2002.  
28 Available at [www.econtech.com/library/doj\\_072302.pdf](http://www.econtech.com/library/doj_072302.pdf)

29 76 Although the authors do not cite the source of their funding in the  
30 paper, evidence adduced in the current Section 271 proceeding in Minnesota has identified  
31 Qwest as that source. *In the Matter of a Commission Investigation into Qwest's Compliance*  
32 *with Section 271(d)(3)(C) of the Telecommunications Act of 1996 that the Requested*  
33 *Authorization is Consistent with the Public Interest Convenience and Necessity, Before the*  
34 *Minnesota Public Utility Commission, PUC Docket No. P-421/CI-01-1373, Qwest response to*  
35 *DOC Information Request 18059*

1 facilities, local access and long-distance facilities, to earn this higher margin  
2 When the BOC decreases the price slightly, it sells more access and more long-  
3 distance services and earns approximately \$0.06 per minute. In contrast, if an  
4 IXC decreases the price, it only receives the additional margin from increased  
5 sales of long-distance service of \$0.04 per minute. Thus, the BOC has a greater  
6 incentive to charge lower long-distance prices than does an IXC. Furthermore,  
7 when the BOC lowers the long-distance price, the IXCs will lower their prices,  
8 which will increase the number of long-distance minutes demanded and conse-  
9 quently the number of access minutes demanded from the BOCs.

10

11 51 The adoption by Verizon and SBC of a “double marginalization” pricing strategy, as  
12 Hausman *et al* believe has occurred, belies the repeated claims by the RBOCs that they no  
13 longer have market power in the local exchange and access services markets. HLS observe  
14 that

15

16 Although the original example of double marginalization was in the case of  
17 monopoly, it is [sic] applies as well to imperfect competition, which character-  
18 izes telecommunications markets because of the large fixed and common costs.  
19 The Areeda-Hovenkamp antitrust treatise, for example, observes that “[t]he  
20 double marginalization model appears to make robust predictions that vertical  
21 integration results in increased output and lower prices any time the affected  
22 markets are something less than perfectly competitive.” Under current  
23 regulatory policies, access and long-distance services are both sold at prices  
24 exceeding marginal (incremental) cost, so as to cover the large fixed costs of  
25 local and long-distance networks. Although access reform since the Telecom-  
26 munication Act of 1996 has decreased the BOCs’ access margin, it has not  
27 eliminated the entire margin. Thus, double marginalization still leads to the  
28 prediction that BOC entry into the in-region interLATA market will lead to  
29 lower long-distance prices. Our econometric findings support this economic  
30 analysis, which has not been taken into account by the DOJ and FCC in their  
31 section 271 implementation analyses.<sup>77</sup>  
32

33 If the authors’ empirical findings and claims as to “double marginalization” are accurate, this  
34 condition would indicate that both Verizon in New York and SBC in Texas are in violation of

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35 <sup>77</sup> HLS, at 18, footnotes omitted

1 both the Section 272(e)(3) imputation and the Section 272(a) and (b) separate affiliate  
2 requirements

3

4 52 Moreover, such “double marginalization” will occur as between the BOC and its 272  
5 affiliate *only when the two entities seek to maximize their joint profit* — i.e., when they  
6 explicitly *do not deal with each other at arm’s length* as expressly required by Section  
7 272(b)(5), and instead pursue a strategy that converts the “wall” that the *Act* sought to create  
8 between the BOC and long distance entities into a transparent and porous membrane whose  
9 purpose is entirely limited to serving as the perfunctory demarcation point for the required  
10 compliance postings and filings. The intent of the statute is to assure that the BOC’s long  
11 distance affiliate gains no competitive advantage vis-a-vis nonaffiliated IXCs, which implies  
12 that it should view all payments to the BOC for both tariffed (e.g., access) and non-tariffed  
13 services as “costs” and make all pricing and output decisions without regard to the fact that  
14 such “payments” to the BOC will create offsetting profits in the BOC entity itself

15

16 53 Consider, for example, the matter of the billing and collection services that are  
17 furnished by the BOC to the 272 affiliate. Where the 272 affiliate’s customer is also a BOC  
18 local service customer (as I have noted, SBC’s 272 long distance affiliate, SBCS, in fact, will  
19 *only* provide service to customers of the local SBC operating company<sup>78</sup>), the incremental  
20 cost to the consolidated enterprise of including a customer’s long distance billing on the local  
21 service bill — which will need to be prepared and mailed, and the payment received and  
22 processed, whether or not the customer subscribes to the affiliate’s long distance service — is

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23 78 The SBC website indicates that “SBC Long Distance provides long distance where  
24 arrangements exist with local providers in the SBC Southwestern Bell Telephone Company  
25 service area. Queries to the cite indicate that this service is not available to CLEC customers.  
26 [http://www.SWBell.com/Products\\_Services/Residential/ProdInfo\\_1/1,1973,187--6-3-15,00.html](http://www.SWBell.com/Products_Services/Residential/ProdInfo_1/1,1973,187--6-3-15,00.html)

1 extremely small. No additional envelope or postage will be required,<sup>79</sup> and the costs of  
2 receiving and processing a payment will be entirely unaffected whether or not the payment  
3 includes the long distance charges.

4  
5 54 According to the Section 272(b)(5) disclosure information provided on Verizon's  
6 website, Verizon New York's charge to its Verizon Long Distance ("VLD") affiliate for  
7 billing and collection services is \$1.15 per account (plus postage, which varied based on  
8 weight)<sup>80</sup>. Since the incremental cost to VNY for these services is at or near zero,  
9 especially considering that postage is similar if not exactly the same were Verizon to bill only  
10 for local service, virtually all of the \$1.15 "cost" to VLD represents "profit" to VNY, from  
11 the standpoint of the consolidated enterprise, then, any such "payments" by one entity to  
12 another are essentially a "wash" and can be ignored if Verizon is following a "maximizing  
13 joint profits" double marginalization strategy. By contrast, other long distance providers not  
14 affiliated with Verizon will incur real out-of-pocket costs for the billing and collection  
15 functions, whether purchased from Verizon at the same terms as are nominally being  
16 "offered" to VLD, or are accomplished via stand-alone billing and collection activities  
17 undertaken by the IXC.

18  
19 55 The "double marginalization" theory also raises serious concerns as to BOC  
20 compliance with cost imputation requirements and the opportunities *and incentives* available  
21 to them to impose price squeezes on their rivals. If VNY/VLD and SWBT/SBCS pricing  
22 conduct is driven by the goal of maximizing joint profit, it is then necessary for the

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23 79 In most cases, only one or two additional pages of billing will need to be produced,  
24 and can be included in the same envelope with no additional postage.

25 80 <http://www.verizonld.com/pdfs/VLDTransactionDetailWebPage1.pdf>

1 downstream entity (VLD or SBCS) to essentially ignore any "payments" it makes to the  
2 upstream entity (VNY or SWBT) in setting its retail prices, and in fact to base those prices  
3 solely upon the underlying joint costs of both entities' services. Return to the HLS example  
4 where they posited that the access charge produces a \$0.02 profit for the BOC entity and the  
5 retail long distance service produces a \$0.04 "profit" relative to the downstream long distance  
6 affiliate entity's payment of access charges and incurrence of other costs. Now suppose that  
7 the two entities determine that the profit-maximizing price of the long distance service should  
8 be reduced by \$0.02, bringing the per-minute joint profit to \$0.04. Nonaffiliated IXCs would  
9 be forced to reduce their prices by a like amount in order to remain competitive, slashing  
10 their profit margins by 50% (i.e., from \$0.04 to \$0.02). They would still be forced to pay the  
11 full price of access to the BOC entity, which would continue to earn the full \$0.02 access  
12 profit on all such purchases. Combining this with other "double marginalization" pricing and  
13 transactional incentives, such as billing and collection services and joint marketing, any  
14 semblance of "imputation" or "parity" in the pricing of services to nonaffiliated IXCs would  
15 be eradicated.

16

17 56. AT&T has alleged that SWB in Texas is ignoring access charges in exactly the  
18 manner described by HLS. Based in part on information provided as part of the requirement  
19 of Section 272(b)(5) that all affiliate transactions between the BOC and its Section 272  
20 affiliate must be made at arm's length, reduced to writing, and made available for public  
21 inspection, AT&T filed a complaint with the Public Utility Commission of Texas on July 30,  
22 2001 claiming that SBC and SBCS were engaging in exactly the type of double  
23 marginalization that HLS describe. As AT&T explains:

24

25 When SWBT and SWB-LD sell intrastate switched long distance service at a  
26 rate of 6 cents per minute, the net revenue to SWB-LD, after paying SWBT's  
27 charges for switched access services, is approximately 0.33 cents per minute.  
28 However, based on public information in contracts between SWBT and SWB-LD

1 filed on the SBC website, AT&T estimates that SWB-LD has a minimum of  
2 additional billing and marketing expenses of at least 3 4 cents per minute solely  
3 attributable to expenses incurred from affiliate transactions. In addition, SWBT  
4 and SWB-LD witness have filed sworn testimony at the FCC that indicates  
5 SWB-LD incurs an additional expense of 1-2 cents per minute for underlying  
6 carrier expenses. These expenses of at least 10-11 cents per minute cannot be  
7 fully recovered under SWB-LD's existing pricing structure. Moreover, it should  
8 be recognized that for certain rate plans, SWBT and SWB-LD explicitly  
9 recognize, and tout, that a customer's cost of SWBT and SWB-LD intrastate  
10 long distance telephone service can be less than a penny a minute-- significantly  
11 below the cost of switched access service alone. Based on the foregoing, AT&T  
12 respectfully submits that at least several of SWBT's and SWB-LD's current rates  
13 for intrastate long distance service, not to mention interstate long distance  
14 service, are below cost and predatory  
15

16 The facts offered by AT&T indicate that SWBT and SWB-LD have been violating the  
17 imputation requirements of Section 272(e)(3). Although Section 272(e)(3) is not covered by  
18 the sunset provision being considered by the Commission at the present, the information  
19 enabling AT&T to determine the existence of predatory pricing would no longer be available  
20 were this Commission to allow Section 272(a) and (b) to sunset

21

22 57. If VLD was truly maintaining an arm's length, separate affiliate relationship with  
23 Verizon New York, it would be forced, when setting its own retail prices, to give effect to  
24 these account-specific payments to VNY as representing out-of-pocket *costs*. VNY would  
25 not, for example, be able to offer no-monthly-fee discount rate plans if it were subject to  
26 fixed per-account expenses. In fact, of course, VLD introduced precisely this type of pricing  
27 as soon as it was permitted to begin offering interLATA services in New York and has  
28 maintained this same pricing policy both in New York and in other Verizon 271 jurisdictions  
29 ever since. VLD and VNY are jointly behaving precisely as Hausman *et al*'s "double  
30 marginalization" theory would suggest. Hence, it is not the "increased competition" resulting  
31 from VLD's long distance entry that brings prices down, it is the fact that the long distance  
32 and ILEC entities are acting *in concert* and not at arm's length, that they are working together

1 to maximize joint profit rather than their respective individual profits, that “explains” the  
2 empirical results that Hausman *et al* claim to have identified. And it is precisely that type of  
3 *in concert* conduct that is expressly prohibited.

4  
5 58. A graphic demonstration of the BOCs’ potential ability to favor their own long  
6 distance business unit can be found in a “contract tariff” for switched access services that  
7 BellSouth recently introduced.<sup>81</sup> The discrimination is accomplished by tying a succession  
8 of “discounts” to “growth” in aggregate switched access usage over the five-year term of the  
9 contract tariff. As a new entrant into the in-region long distance market, the BOC affiliate  
10 starts out with minimal switched access demand, and thus will have little difficulty achieving  
11 a relatively high *rate* of growth. By contrast, the existing IXCs, some of which may be  
12 purchasing considerably more switched access service than the BOC affiliate will at the  
13 outset, are not likely to experience comparable *rates* of growth; indeed, to the extent that the  
14 BOC affiliate is successful in taking customers away from the IXCs, those IXCs may actually  
15 be experiencing *negative* growth. In any event, if the IXC is already purchasing quantities of  
16 switched access services that exceed the upper bound of the discount range — 4,401,406,922  
17 minutes in the case of BellSouth’s tariff — the putatively “available” discount price would as  
18 a practical matter not be available to carriers other than the BOC affiliate.<sup>82</sup> The effect of  
19 this growth-driven pricing device is ultimately to afford the BOC long distance affiliate lower  
20 rates than would be available to other IXCs with which it competes. Of course, if the

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21 81. BellSouth Telecommunications, Inc., FCC No. 1, 520<sup>th</sup> Revised Page 1, 8<sup>th</sup> Revised  
22 Page 9 0 9, Effective May 18, 2002.

23 82. I have no specific knowledge that BellSouth Long Distance, the BellSouth Section 272  
24 affiliate, is actually purchasing switched access services out of this contract tariff. However,  
25 the *fact* that this type of tariff has been introduced serves to demonstrate the *opportunity* that  
26 a BOC would have to favor its affiliate in the guise of a generally available tariff offering.

1 separate affiliate requirement is allowed to sunset, the BOC's long distance business unit  
2 (which may then be formally integrated into the BOC ILEC entity) will no longer be required  
3 to "buy" tariffed switched access services at all, and will instead be allowed simply to utilize  
4 the BOC's network access resources subject only to the far more malleable "imputation"  
5 requirement of Section 272(e)(3).

6  
7 59 Importantly, if the separate affiliate requirement is allowed to sunset and the Section  
8 272(b)(1) "operate independently" and 272(b)(5) "arm's length" requirements are eliminated,  
9 BOCs will no longer be under any obligation to "sell" access services to their long distance  
10 business units at tariff rates. The sole remaining "safeguard" against discrimination with  
11 respect to access services will be Section 272(e)(3), which is not subject to the sunset  
12 provision. Section 272(e)(3) requires the BOC to ". . . impute to itself (if using the access for  
13 its provision of its own services), an amount for access to its telephone exchange service and  
14 exchange access that is no less than the amount charged to any unaffiliated interexchange  
15 carriers for such service." "Imputation" requirements of this type are applied by state  
16 commissions in the case of ILEC-provided competitive *intraLATA* toll services, but due to the  
17 absence of explicit access charges, precise application of such rules is particularly difficult.  
18 ILECs have argued, for example, that they are free to aggregate different services together in  
19 demonstrating that the imputation requirement has been satisfied, which may permit certain  
20 services to be priced below the imputation level only to be offset (i.e., cross-subsidized) by  
21 others whose prices exceed the applicable access charges. Such contentions have been  
22 rejected by state commissions,<sup>83</sup> but only after the practice had been underway for some

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23 83 See, e.g. *Application of Qwest Corporation for an Increase in Revenues*, Oregon Public  
24 Utilities Commission, Order no. 01-810, 2001 Ore. PUC LEXIS 449, September 14, 2001,  
25 (order unpaginated, at "Access Charge Imputation" section), and *Application of US West*  
26 *Communications, Inc. for the Commission to Open an Investigatory Docket to Eliminate on*  
27

(continued...)

1 time and following often protracted litigation. Proper application of an imputation  
2 requirement such as that contained at Section 272(e)(3) would require the BOC to  
3 demonstrate that its retail price exceeds the sum of the imputed access charges together with  
4 all costs incident to the value-added (long distance) services of which those access services  
5 are a component. Short of protracted complaint proceedings, I am not aware of any  
6 remaining mechanism, once the separate affiliate requirement has been permitted to sunset,  
7 that would permit the Commission or affected competitors to verify compliance with Section  
8 272(e)(3).

9  
10 60 As another example of joint BOC/affiliate pricing actions whose effect is to create a  
11 price squeeze for competing providers, consider the types of “tie-in” arrangements that  
12 Verizon Long Distance and Verizon New York have pursued as part of their “joint  
13 marketing” program. In New York, Verizon Long Distance (“VLD”) was offering a \$4.60  
14 “credit” when a customer selected the basic VLD Schedule “C” (\$0.10 per minute, no  
15 minimum, no monthly charge) calling plan and also subscribed to *Verizon New York’s* “Value  
16 Pack” service, a package of local exchange service and selected vertical features.<sup>84</sup> The  
17 VLD Schedule C rate plan was targeted at the relatively low-use customer who would be  
18 attracted by the absence of either a monthly charge or minimum usage commitment. If, for  
19 example, such a customer were to make no long distance calls at all during a given month,  
20 VLD would sustain a “loss” of at least \$4.60 in that it would still have to “pay” the credit to

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21 83 (continued)  
22 *an Expedited Basis the Requirements that US West Impute Switched Access Rates into the*  
23 *Price Floor of its IntraLATA Long Distance Service*, Colorado Public Utilities Commission,  
24 Docket No. 00A-201T, 2001 Colo. PUC LEXIS 133, January 24, 2001, at \*16.

25 84 Bell Atlantic Communications, Inc. d/b/a Verizon Long Distance, New York PSC  
26 Tariff No. 1, Original Promotional Attachment No. 5 Package No. 1 Promotion and Rate  
27 Schedule (Section 3.5.3).

1 Verizon New York while receiving no offsetting long distance revenue from the customer.  
2 Verizon New York, however, would realize \$17.99 in actual revenues from the customer (the  
3 price of Value Pack service)<sup>85</sup> plus the additional \$4.60 “payment” from Verizon Long  
4 Distance. VNY gains \$22.59 while VLD “loses” \$4.60, which still results in a net gain to the  
5 consolidated Verizon bottom line of \$17.99, erasing the VLD “loss” when examined at the  
6 enterprise level. VLD’s ability to offer this “promotion” and to potentially sustain the  
7 “losses” arising therefrom is solely and uniquely attributable to its affiliate relationship with  
8 the Verizon BOC. Verizon has just announced the availability in its Section 271 states of  
9 several new “packages” of local, long distance and DSL services under the brand name  
10 “Variations<sup>SM</sup>” that offer discounts of up to \$15 if the customer orders a package consisting of  
11 local service with unlimited intraLATA calling, 14 custom calling features, DSL and Verizon  
12 (interLATA) Long Distance.<sup>86</sup> It’s not clear how this \$15 discount will be allocated as  
13 between the VNY and VLD entities, but from the standpoint of the parent company, it  
14 doesn’t actually matter.

15

16 61. Of course, from the perspective of any *competing* non-affiliated interexchange carrier  
17 attempting to make a comparable “promotional” offer, it certainly does matter. That same  
18 \$4.60 “credit” (and whatever new “credit” is associated with the *Variations<sup>SM</sup>* package) would  
19 be a real *cash payment*, representing a true out-of-pocket cost to the IXC. In Verizon’s case,  
20 even though the inter-affiliate “payment” is (presumably) actually being recorded on the two  
21 entities’ respective books, VLD is behaving as if no such “payment” is actually taking place.

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22 85. <http://www22.verizon.com/foryourhome/SAS/StateSelector.asp?ID=choosefeat>, accessed  
23 07/23/2002

24 86. Verizon News Release, “Verizon Adds DSL to High Value Service Bundle,” July 23,  
25 2002

1 The effect of these “promotional” or “tie-in” offers is to impose an anticompetitive price  
2 squeeze on VLD’s long distance rivals

3

4 **The integrated relationship between the BOC and its Section 272 Affiliate is also**  
5 **reflected in distorted inter-affiliate pricing related to joint marketing of local and long**  
6 **distance services.**

7

8 62. Verizon New York’s provision of “joint marketing” services to VLD, the 272  
9 affiliate, provides perhaps an even more compelling example of conduct whose effect is to  
10 ignore the nominal existence of the separate long distance affiliate. A BOC’s authority to  
11 engage in joint marketing of its own local services with its affiliate’s long distance service is  
12 found at Section 272(g)(3) of the federal *Act*, which operates to exempt a BOC’s joint  
13 marketing of local and long distance service from the broader nondiscrimination requirements  
14 of Section 272(c)

15

16 272(g)(3) RULE OF CONSTRUCTION- The joint marketing and sale of  
17 services permitted under this subsection shall not be considered to violate the  
18 nondiscrimination provisions of subsection (c).

19

20 The Section 272(g)(3) joint marketing carve-out, however, is limited solely to the “nondis-  
21 crimination provisions” of Section 272(c), which is found at 272(c)(1), and does not exempt  
22 such joint marketing activities from 272(c)(2), which requires that a Bell operating company

23

24 shall account for all transactions with an affiliate described in subsection (a) in  
25 accordance with accounting principles designated or approved by the  
26 Commission

27

28 Nothing in subsection 272(g)(3) in any way exempts a BOC or its section 272(a) interLATA  
29 affiliate from the requirements of Section 272(b)

30

1           63. Disclosures and postings that Verizon and SBC have been required to make with  
2 respect to Section 272(b) affiliate transactions confirm that there are extensive and  
3 uncompensated information flows going from the BOC entity to the long distance affiliate,  
4 and that the affiliate is not being required to pay the BOC entity anything remotely close to  
5 the full and fair market value of such information and for the services that it receives from  
6 the BOC. In addition to furnishing personnel to support the joint marketing function, Verizon  
7 New York also provides its long distance affiliate with unfettered access to VNY's customer  
8 base and to the *inbound* customer-initiated contacts that arise as a consequence of VNY's  
9 dominant control of the New York residential local service market. Competing long distance  
10 providers must engage in extensive advertising, direct mail, and telemarketing to promote  
11 their service, and do not get anywhere near the quantity of inbound customer contacts as does  
12 the BOC, and those which IXCs do receive are primarily the result of the IXCs' advertising  
13 and other promotional efforts, undertaken at not inconsiderable cost to those IXCs.

14  
15           64. Customer acquisition is among the most costly aspects of an interexchange carrier's  
16 operation. Without the benefit of the embedded ubiquitous customer base that is uniquely  
17 available to VLD, other IXCs must pursue active marketing strategies involving extensive  
18 media advertising, telemarketing, direct mail, and special promotions (cash, airline miles,  
19 etc.) When spread over the number of sales that are actually consummated, these costs can  
20 amount to hundreds of dollars per customer acquired. I am aware of at least one analysis that  
21 has put such cost at "up to \$300 to \$600 in sales support, marketing and commissions" per  
22 customer acquired.<sup>87</sup> The prevailing industry customer acquisition cost represents the fair  
23 market value of the customer acquisition services that a BOC provides to its 272 affiliate.

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24           87 See Borna, Claude, "Combating Customer Churn," in *Business and Management*  
25 *Practices*, Vol. 11, No. 3, Pg. 83-85, ISSN: 0278-4831, Horizon House Publications, Inc.,  
26 Telecommunications Americas Edition (March, 2000).

1 Yet according to Verizon's 272(b)(5) disclosures, VLD's "payments" to VNY for customer  
2 acquisition/joint marketing services are only \$7.71 per contact;<sup>88</sup> SBC has identified the  
3 amount of such charges by its Texas BOC, SWBT, to the SBCS long distance affiliate at  
4 \$9 90 per acquisition.<sup>89</sup> The magnitude of such payments is woefully short of the fair  
5 market value of these services and of the customer information that is being beneficially  
6 furnished by the BOCs to their affiliates Through its use of the joint marketing channel,  
7 Verizon LD is able to save hundreds of dollars in marketing costs per customer.

8  
9 65 Verizon and SBC improperly price joint marketing services using Fully Distributed  
10 Cost methodologies instead of Fair Market Value. The Commission explicitly requires that  
11 BOCs price all services provided to their Section 272 Affiliate that are not subject to tariff or  
12 Prevailing Company Pricing, at the higher of fair market value or fully distributed cost.  
13 Should the service not be available on the open market, this Commission required that a BOC  
14 *estimate* a fair market value<sup>90</sup> Yet instead of the conducting the required study and  
15 estimating the inbound channel's value, Verizon presented the Section 272 Auditors with a

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16 88. <http://www.verizonled.com/pdfs/exhibit46zhamendment34.pdf>

17 89 [http://www.sbc.com/public\\_affairs/regulatory\\_documents/affiliate\\_agreements/300-](http://www.sbc.com/public_affairs/regulatory_documents/affiliate_agreements/300-)  
18 [993pa5-02.xls](http://www.sbc.com/public_affairs/regulatory_documents/affiliate_agreements/300-993pa5-02.xls), accessed 7/25/2002

19 90 In its *Accounting Safeguards Order*, at 17610, the Commission sets forth "the baseline  
20 for a good faith determination of fair market value by requiring carriers to use methods that  
21 are routinely used by the general business community" The Commission anticipated that  
22 some services would be unique and found, "[w]hen situations arise involving transactions that  
23 are not easily valued by independent means, we require carriers to maintain records sufficient  
24 to support their value determination" Finally, the Commission notes, "nothing discussed here  
25 exempts carriers from their statutory obligation under section 220(c) to justify their  
26 accounting entries."

1 letter stating that “FMV could not be obtained for these services.”<sup>91</sup> Moreover, Verizon  
2 failed to explain why it did not obtain an *estimate* of the fair market value for these services

3  
4 66 It is instructive to compare and contrast Verizon’s inter-entity pricing practices as  
5 between billing and collection services, on the one hand, and customer acquisition/joint  
6 marketing services, on the other. Since VNY offers and in fact provides billing and  
7 collection services to nonaffiliated IXCs, it is required to “charge” the same price for such  
8 services to its Section 272 affiliate as it does with respect to equivalent services furnished to  
9 nonaffiliated entities.<sup>92</sup> Not surprisingly, VNY’s “price” for these services has been set at  
10 “fair market value,” well in excess of its actual incremental cost. By contrast, VNY is *not*  
11 required to provide “joint marketing” services to nonaffiliated IXCs,<sup>93</sup> and by extension is  
12 not required to “offer” comparable or nondiscriminatory terms and conditions with respect to  
13 such services to nonaffiliated entities. Not surprisingly, VNY prices these services at what it  
14 claims to be fully-distributed cost (“FDC”),<sup>94</sup> resulting in a per-transaction “price” of only  
15 \$7.71, a minute fraction of the fair market value of the customer acquisition services that it  
16 provides to VLD

17

18 67. There is thus no evidence that the dollar amounts being reflected on the two entities’  
19 books bear any resemblance to the proper valuation of the services being provided, i.e., the

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20 91 Verizon Communications Inc. Section 272 Biennial Agreed-Upon Procedures  
21 Engagement, filed in *Implementation of the Telecommunications Act of 1996: Accounting*  
22 *Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, Filed  
23 February 6, 2002, Appendix A at 21

24 92 47 U.S.C. § 271(c)(1)

25 93 47 U.S.C. § 272(g)

26 94 *Supra.* footnote 88

1 amounts that firms dealing with each other on a truly arm's length basis would demand. The  
2 conduct of VNY/VLD and SWBT/SBCS transitions are, indeed, consistent with the "double  
3 marginalization" theory, and *inconsistent* with any finding that anything beyond "lip-service"  
4 is being afforded by either RBOC to the Section 272(a) and (b) separate affiliate  
5 requirements.

6

7 **The Section 272 separate affiliate requirement provides an essential transition between**  
8 **the former BOC long distance line-of-business restriction and a possible future in which**  
9 **the BOCs' market power with respect to local telecommunications access and services**  
10 **will have been eroded by the arrival of effective competition.**

11

12 68 Section 271 was adopted as a *replacement* for the MFJ long distance line of business  
13 restriction, and established a process by which BOCs could enter the "in-region" long distance  
14 market provided that they implemented a series of specific measures that were to have the  
15 effect of irreversibly opening their previously monopolized local telecommunications markets  
16 to competitive entry. To the extent that the *local* market itself becomes competitive, the  
17 BOCs' ability to exert market power in the adjacent long distance market would be  
18 attenuated. Conversely, however, to the extent that competition *fails to develop* in the local  
19 services market, the BOC will then have both the incentive and the ability to exert market  
20 power in, and ultimately to remonopolize, the adjacent long distance market.

21

22 69 Since the MFJ, competition in the long distance market has thrived — and as a  
23 result prices have sharply decreased — in the nearly two decades since the MFJ first went  
24 into effect in January, 1984. The principle generally underlying Section 271 is that once  
25 there is sufficient competition in the *local* service market, it will then no longer be possible  
26 for a BOC to extend its local monopoly into the adjacent long distance market. The existence  
27 of but a *single* facilities-based competitor somewhere in any state — one of the threshold

1 conditions that a BOC must satisfy to obtain Section 271 approval<sup>95</sup> — is clearly not by  
2 itself sufficient to constrain the incumbent BOC's exercise of market power.

3  
4 70 Congress established the Section 272 separate affiliate requirement and, in particular,  
5 the 272(b)(1) "operate independently" and 272(b)(5) "arm's length" provisions, specifically to  
6 wall-off the BOC ILEC and IXC entities from acting in concert to the detriment of long  
7 distance competitors. For so long as the BOCs maintain market power with respect to local  
8 services and local network access, they retain both the ability and the incentive to exploit  
9 preexisting customer relationships and the "inbound marketing channel" with respect to new  
10 customers to direct and to divert customers to their long distance offerings

11  
12 **As a result of the BOCs' local market power, CLECs are unable to enjoy the same**  
13 **"double marginalization" benefits, a factor that ensures the BOCs and their affiliates**  
14 **will be able to expand their already substantial long distance market share to monopoly**  
15 **levels.**

16  
17 71 Verizon and SBC's ability to gain significant long distance market share is  
18 undoubtedly due to their local market power. As I have discussed above, the pricing plans  
19 offered by the BOC Section 272 affiliates are premised upon the ability of the BOC and its  
20 Section 272 affiliate to operate as if interaffiliate payments for fixed costs such as billing did  
21 not exist. Virtually all marketing costs associated with customer acquisition were avoided by  
22 the Section 272 affiliate, despite the clear requirement of Section 272(b)(5) that the BOC  
23 marketing services should have resulted in arm's length marketing fees paid by the 272  
24 affiliate to the BOC. Avoiding these costs is the only economic reason why the BOC  
25 interLATA affiliates are able to offer pricing plans such as their no-minimum, no-monthly fee  
26 offer

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27 95 47 U.S.C. § 271(c)(1)(A)

1           72 BOC local market power allows integrated offers that simply are not possible for  
2 competitors to match. As the default local service provider, the BOC does not need to  
3 engage in additional advertising or customer acquisition costs to attract local customers, and  
4 once the local customers are acquired, the BOC is allowed to preemptively sell the customer  
5 the affiliate's long distance service. Even assuming that a CLEC were able to attract a market  
6 share approaching that of the BOCs, the CLEC's relatively new position in the local market  
7 does not allow the CLEC to enjoy similar cost avoidance. While a CLEC's long distance  
8 service would enjoy similar customer acquisition and billing benefits as the BOC affiliate, the  
9 CLEC's *local* service provision would be required to incur massive marketing outlays in order  
10 to attract local customers, at costs that are likely to be similar to or higher than those required  
11 to attract long distance customers. Those marketing costs, unique to CLECs, would increase  
12 the CLECs' cost of providing service above that of the BOC.

13

14           73 The purpose of Section 272 was to prevent exactly this kind of integrated pricing  
15 until CLECs were similarly positioned to take advantage of the same type of economies.  
16 CLECs will not be so positioned until the BOC no longer enjoys market power in the local  
17 market. As long as the BOC is permitted to exploit its captive relationship with the vast  
18 majority of local service customers to market and sell its affiliate's long distance services,  
19 BOC long distance shares will grow rapidly and non-BOC IXCs will suffer a precipitous  
20 decline in customers and demand. Faced with such losses, IXC costs will rise and at least  
21 some IXCs will be forced to exit the business, further exacerbating the situation and affording  
22 the BOCs an opportunity to remonopolize the nation's long distance market.

23

1 **Conclusion**  
2

3 74 The Section 272(a) and (b) separate affiliate requirement and the Section 272(c) and  
4 (e) nondiscrimination requirements were included in the 1996 *Act* specifically to limit the  
5 BOCs' ability, following their receipt of Section 271 in-region interLATA authority, to  
6 leverage their market power in local exchange and access services into the adjacent and  
7 competitive long distance market The BOCs' market power with respect to local exchange  
8 and access services has not materially diminished since the February 1996 date of enactment  
9 The need to wall-off the BOCs' competitive long distance entity from their largely  
10 monopolistic local service operation is as strong and important today as it was six years ago  
11 and, if anything, there is now a compelling need to *strengthen* the Section 272(b) structural  
12 separation requirements in light of actual "on the ground" experience with BOC in-region  
13 long distance activities To the extent that, by virtue of their continuing dominance of the  
14 market for local and access services, the BOCs can continue to operate the two nominally  
15 separate entities as if they were fully integrated, to pursue pricing and marketing strategies  
16 that are designed to maximize joint profit, to ignore imputation requirement, to impose price  
17 squeezes upon competing CLECs and IXCs, and to cross-subsidize their long distance  
18 business by failing to compensate monopoly local service ratepayers for the value that the  
19 long distance business gains from inter-affiliate transfers, the prospect of near-total and rapid  
20 remonopolization by the BOCs of the nation's long distance market is quite real

21  
22 75 Congress established the Section 272 separate affiliate and nondiscrimination require-  
23 ments and, in particular, the Section 272(b)(1) "operate independently," 272(b)(5) "arm's  
24 length," and Section 272(e)(3) "imputation" provisions, specifically to prevent the BOC ILEC  
25 and IXC entities from acting in concert to the detriment of long distance competitors Section  
26 272 was designed to prevent collusive, discriminatory and exclusionary practices by a BOC in

1 the operation of its long distance business until CLECs were similarly positioned to take  
2 advantage of the same type of integration economies. CLECs will not be so positioned until  
3 the BOC no longer enjoys market power in the local market. As long as BOCs are permitted  
4 to exploit captive relationships with the vast majority of local service customers to market and  
5 sell long distance services, BOC long distance shares will grow rapidly and non-BOC IXCs  
6 will suffer a precipitous decline in customers and demand. Faced with such losses, IXC costs  
7 will rise and at least some IXCs will be forced to exit the business, further exacerbating the  
8 situation and affording the BOCs an opportunity to remonopolize the nation's long distance  
9 market.

10

11 76. While the Section 272 separate affiliate requirement cannot *guarantee* that BOCs  
12 will not engage in cross-subsidization, discrimination, price squeezes or other anticompetitive  
13 conduct, the retention of the separation requirement clearly makes such behavior somewhat  
14 more difficult and in any event facilitates its *detection*. It is critical that the Commission  
15 retain -- and strengthen -- the separate long distance affiliate requirement until such time as  
16 the BOC no longer dominates the local service market in the geographic area and consumer  
17 or business market in which it provides service

18

19 The foregoing statements are true and correct to the best of my knowledge, information  
20 and belief

  
LEE L. SELWYN