

1 channel of a subscriber loop available on an unbundled basis for use in providing ADSL (so-
2 called "line sharing") will be eliminated.⁴⁷ Although the text of that Order has not been issued as
3 of the date of this Declaration, elimination of "line sharing" would for all intents and purposes
4 make the ILEC the only source of ADSL service available to any of the ILEC's residential and
5 small business customers. That dynamic has the potential to profoundly alter the nature of the
6 information services market, and extrapolations from past experience cannot be used as a basis
7 for projecting future conditions. If BOCs maintain their existing dominance of mass market
8 local services and if they are also under no obligation to provide nonaffiliated ISPs with "open
9 access" to their ADSL services, the BOCs would then have both the ability and the incentive to
10 leverage their local service/ADSL monopoly into the adjacent Internet services market, and
11 come to dominate that (now highly competitive) market as well.

12

13 *Customer premises equipment (CPE) and inside wire.*

14

15 35 At the time of the break-up of the former Bell System, the BOCs were forced to transfer
16 their "embedded base" of customer premises equipment ("CPE") to AT&T and were required to
17 provide new CPE through a separate affiliate. Without that embedded base of CPE as a founda-
18 tion, the BOCs chose not to reenter the CPE market, and have still not done so even though,
19 since 1996, the BOCs have been permitted to provide CPE on an integrated basis

20

47 FCC, News Release, "FCC Adopts New Rules for Network Unbundling Obligations of Incumbent Local Phone Carriers." February 20, 2003

1 36 In 1977 and 1978, the FCC adopted the Part 68 “equipment registration” program
2 applicable to *all* CPE, whether provided by a BOC or other ILEC, or by the customer⁴⁸ That
3 action, together with the subsequent “unbundling” of the “primary instrument” from the basic
4 dial tone line and the transfer of embedded CPE out of the BOCs, fundamentally and irreversibly
5 changed the distribution channel for both consumer and business CPE. Rather than renting tele-
6 phone sets and other station equipment as part of the process of ordering local telephone service,
7 consumers were instead offered the ability to *purchase* this equipment outright through ordinary
8 retail channels, such as Radio Shacks, K-Mart’s, and thousands of other retail outlets. CPE so
9 purchased could then be plugged into the customer’s telephone line in much the same way as
10 electrical appliances were plugged into the customer’s electric service. As a result, CPE was no
11 longer limited to the familiar telephone handsets that were the mainstay of ILEC-provided equip-
12 ment, and thousands of new consumer-oriented products have been introduced, *each one of*
13 *which may be connected to the PSTN via the standard RJ-11 interface*. Business telephone
14 systems — PBXs and the like — experienced a corresponding restructuring of distribution
15 channels, with numerous new manufacturers and their retail dealers entering the market.

16
17 37 Put simply, the CPE “bottleneck” problem was solved by the simple adoption of the
18 standard “RJ-11” plug and jack — and consumers and CPE providers don’t even have to buy
19 their RJ-11 jacks from the phone company, because the Commission had also deregulated

48 *Proposals for New or Revised Classes of Interstate and Foreign Message Toll Telephone Service (MTS) and Wide Area Telephone Service (WATS)*, Docket no. 19528, *Memorandum Opinion and Order*, Rel. June 20, 1977, 64 F.C.C.2d 1058; *Third Report and Order*, Rel. April 13, 1978, 67 F.C.C.2d 1255

1 another CPE-related bottleneck — inside wire. Since CPE interconnection is now accomplished
2 by a standard RJ-11 plug-and-jack and since these products are now being sold by retail channels
3 ranging from local convenience stores to specialized consumer electronics dealers, there is no
4 particular cost or competitive benefit that a BOC could derive from the OI&M and marketing
5 integration that is now permitted for CPE, and indeed no such integration has actually occurred
6 because the BOCs are not in the CPE business to begin with. Thus, contrary to Dr. Tardiff's
7 "example," the fact that CPE may be provided and marketed by BOCs on an integrated basis
8 with local telephone service teaches *nothing* about what the BOCs will be able to achieve with
9 respect to long distance remonopolization should the OI&M restriction be lifted with respect to
10 interLATA services

11

12 38 Interestingly, ILECs *have* attempted to preserve their preexisting monopoly in the
13 inside wire maintenance business by exploiting preexisting relationships with monopoly local
14 service customers, such as in attempting to sell deregulated "inside wire maintenance services"
15 on inbound contacts from local service customers. For example, the California PUC has
16 received numerous complaints that Pacific Bell engages in exactly the type leverage of local
17 market power the Verizon tries to deny. The California PUC required "the utilities to inform
18 their customers that competitive alternatives may be available. This notification should be
19 provided during customer calls to 611 repair services and when a repair employee is on the
20 customer's premises and has identified a possible inside wire problem."⁴⁹ Complaints were

49 *In the Matter of the Application of Pacific Bell, a corporation, for authority to increase*
(continued...)

1 lodged with the CPUC by the Office of the Ratepayer Advocate and The Utility Reform Net-
2 work that Pacific Bell violated this safeguard⁵⁰ Other BOCs have been accused of engaging in
3 “negative option” marketing of their “optional” inside wire maintenance services, leaving the
4 monthly charge on the customer’s bill as of the deregulation date until such time as the customer
5 affirmatively asks that the “service” be discontinued⁵¹ These examples show that BOCs are
6 willing to use their local service monopoly to benefit competitive service offerings.
7

49 (. continued)
certain intrastate rates and charges applicable to telephone services furnished within the State of California. And Related Matters, Before the California Public Utilities Commission, Decision No 90-06-069, June 20, 1990, 36 CPUC 2d 609, 626

50 *In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, for Authority to Categorize Business Inside Wire Repair, Interexchange Carrier Directory Assistance, Operator Assistance Service and Inmate Call Control Service as Category III Service. In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, For Authority to Categorize Residential Inside Wire Repair as a Category III Service, Before the California Public Utilities Commission, CPUC Decision No. 99-09-036, September 2, 1999, 1999 Cal PUC LEXIS 603, *18 This requirement was clarified in *The Utility Consumers' Action Network, Complainant, vs Pacific Bell (U 1001 C), Defendant; And Related Matters, Before the California Public Utilities Commission, CPUC Decision No 01-09-058, September 20, 2001, 2001 Cal PUC LEXIS 914, *57. The CPUC did not make any findings or conclusions about Pacific’s compliance with these requirements, however, the decision directs Pacific Bell to disclose such information See *The Utility Consumers' Action Network, Complainant, vs Pacific Bell (U 1001 C), Defendant And Related Matters, Before the California Public Utilities Commission, CPUC Decision No 02-02-027, February 7, 2002, 2002 Cal PUC LEXIS 189, *34***

51 *See, e.g Pennsylvania Public Utility Commission v. The Bell Telephone Company of Pennsylvania, Docket No 832316, Before the Pennsylvania Public Utilities Commission, Opinion and Order, Rel April 16, 1984, 1984 Pa PUC LEXIS 53*

1 **Intermodal competition that relies upon services that are not yet mature, viable**
2 **alternatives to wireline service and that themselves often require BOC and ILEC**
3 **bottleneck facilities does not limit the BOCs' ability to dominate the long distance market**
4 **once the separate affiliate requirement has been sunset.**
5

6 39 Carlton *et al* contend that the presence of *intermodal* substitutes for wireline long
7 distance calling works to limit BOC market power.⁵² They posit that wireless services, e-mail,
8 and VoIP (Voice-over-Internet Protocol) all need to be considered in assessing the extent of
9 BOC dominance. Limited substitution among these services is clearly present, but the demand
10 for wireline long distance services remains relatively inelastic.

11
12 40 A quantitative measure of the extent to which wireline long distance services confront
13 intermodal competition is the *own price elasticity* of wireline long distance call demand, an issue
14 that the Commission has grappled with in the past.⁵³ In at least two recent state PUC cases
15 addressing rate reductions for BOC intraLATA toll services, the BOC offered highly inelastic
16 price elasticity estimates, and challenged the less-price-inelastic estimates that were advanced by
17 the commission staffs and by interveners.⁵⁴

52 Carlton *et al*, at paras 26-44.

53 See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, Docket No. 87-313, (FCC 90-314), para. 83 and 84 and Appendix C, released October 4, 1990.

54 Price elasticity can be defined as the percent change in quantity resulting from a 1% change in price. Since, for most "normal" goods and services, the price/quantity relationship is *inverse* (i.e., when price goes up, quantity demanded goes down, and vice versa), price elasticity is generally expressed with a minus sign. Thus, if the price elasticity is, say, -0.4, then for each
(continued..)

1 41 In a 2001 Oregon rate design proceeding implementing a \$64.2-million revenue reduc-
2 tion for Qwest, Qwest had *opposed* the use of a price elasticity factor in adjusting for demand
3 stimulation following its proposed 42% reduction in intraLATA toll prices.⁵⁵ Qwest rejected
4 other parties' recommended price elasticity factors of -0.3632 (advocated by the Oregon PUC
5 Staff) and -0.5 (advocated by AT&T and WorldCom).⁵⁶ Although Qwest refrained from calcu-
6 lating an own-price elasticity in that proceeding, Qwest did suggest that, absent a definitive
7 study, an own price elasticity for intraLATA toll of -0.2 "may be a more reasonable conclu-
8 sion."⁵⁷ Note that all of these estimates suggest *highly inelastic* own-price elasticities, with the
9 -0.2 figure suggested by Qwest being the most inelastic of the various values that had been put
10 forth. While the presence of consequential intermodal competition would imply a relatively high
11 *cross-price elasticity* between wireline long distance and the purported intermodal substitutes, a
12 high cross-price elasticity would also imply a relatively elastic own-price demand if consumers
13 truly viewed the alternative forms of telecommunications as true substitutes for traditional wire-
14 line voice long distance calling. The *highly inelastic* demand being claimed by Qwest and by

54 (continued)
1% drop in price, quantity would be expected to increase by 0.40%, all else being equal

55 In the Matter of the Application of Qwest Corporation for an Increase in Revenues, Oregon PUC Docket UT 125, Phase II, Direct Testimony of David Teitzel on behalf of Qwest Corporation, November 15, 2000, at 37-39

56 In the Matter of the Application of Qwest Corporation for an Increase in Revenues, Oregon PUC Docket UT 125, Phase II, Rebuttal Testimony of Aniruddha Banerjee on behalf of Qwest Corporation, May 3, 2001, at 39-42.

57 *Id.*, at 43

1 other parties with respect to long distance service belies Qwest's and the other BOCs' conten-
2 tions that rampant substitution of services such as e-mail and VoIP for traditional wireline long
3 distance calling is actually taking place

4
5 42 Similarly, in a 2000 Arizona rate case filed by Qwest, the Company's initial filings
6 sought reductions in intraLATA toll rates, yet again no adjustment was made to account for
7 demand stimulation despite recommendations by ACC Staff and the Arizona Residential Utility
8 Consumer Office for the use of an elasticity factor for that purpose.⁵⁸ Although Qwest's own
9 witness conceded that "when Qwest reduces a toll price, such as the reduction in Residential Toll
10 off-peak prices proposed in this Docket from \$0.15 to \$0.10 (a 33% decrease) an economist
11 would expect that a large surge in demand would be the result,"⁵⁹ he went on to assert that, based
12 upon the Company's experiences with toll rate decreases in Washington, Wyoming and

58 By neglecting to account for demand stimulation, Qwest implicitly utilizes a highly inelastic price elasticity factor of 0. While witnesses for Staff and RUCO recommended that the effects of demand stimulation for toll service be accounted for, neither witness advocated for a specific elasticity factor. Nonetheless, *any* such value these witnesses could have recommended would, by definition, be *less inelastic* than Qwest's factor of 0.

59 In the Matter of the Application of US West Communications, Inc., a Colorado Corporation, for a Hearing to Determine the Earnings of the Company, the Fair Value of the Company for Ratemaking Purposes, to Fix a Just and Reasonable Rate of Return thereon and to Approve Rate Schedules Designed to Develop Such Return, Arizona CC Docket No. T-01051B-99-0105, Rebuttal Testimony of David Teitzel on behalf of Qwest Corporation, August 21, 2000, at 24.

1 Nebraska “[t]here is no fact-based reason to expect that intraLATA long distance call volumes in
2 Arizona will be stimulated in response to Qwest’s price proposal in this docket”⁶⁰

3

4 *Wireless*

5

6 43 All BOC commentors cite wireless “substitution” as a viable alternative to wireline long
7 distance service. The BOCs claim that competition from this arena will serve as a check on their
8 long distance wireline long distance prices. The BOCs ignore their own substantial involvement
9 in wireless as well as the effect of “bundling” efforts between their own wireline and wireless
10 operations.

11

12 44. As the FCC noted in its recent Wireless Competition Survey, wireless is not yet a full
13 substitute for wireline service. Specifically, the Commission cited studies where consumers
14 indicate a high level of specific quality of service problems with wireless calls.

15

16 GAO also estimated that, “about 47% of adult mobile phone users believed
17 their call quality was improving, while about 5 percent believed that their call
18 quality was getting worse.” GAO also reported that “[d]espite the many
19 mobile phone customers who appeared to be satisfied with their overall call
20 quality, a number of survey respondents reported that they were experiencing
21 specific problems.” For example, “about one-third of customers could not
22 complete 10 percent or more of their calls because they were in a cell where
23 the carrier did not provide service.” About 12 percent reported that such a
24 problem occurred at least one-third of the time. In addition, just over 20
25 percent of respondents reported problems “getting a call through because [of a]

60 Arizona CC Docket No T-01051B-99-0105, Rejoinder Testimony of David Teitzel on behalf of Qwest Corporation, September 19, 2000.

1 fast busy signal or a message that says the call failed” or problems “with a call
2 being cut off or dropped” at least 10 percent of the time When examining
3 consumer opinions, it is important to keep in mind that consumer perceptions
4 of service quality can change independently of actual changes in network
5 performance, as consumers’ expectations evolve ⁶¹
6

7 Wireless call quality is not yet up to the level of wireline service and, indeed, it is likely that
8 customers do not expect such a level of service quality precisely because they do not yet expect
9 wireless to be a true substitute for wireline service
10

11 45 The marketing plans of Verizon, SBC and BellSouth are also instructive. Each of these
12 companies is bundling local, long distance, and wireless service, a tactic that allows the BOCs to
13 benefit substantially from any wireless substitution. In a recent article discussing the wireless
14 ventures of Verizon and Vodaphone, the *Wall Street Journal* noted that

15
16 The companies [Verizon and Vodaphone] are also at odds in their strategies
17 for owning wireless assets Verizon Communications increasing uses the
18 venture to prop up its declining land-line phone business, by bundling wireless
19 at a discount with other services Vodaphone considers land lines to have no
20 future for consumers and wants little to do with them ⁶²
21

61. *Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993 Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, WT Docket No 02-379, *Eighth Report*, Rel. July 14, 2003, at para. 88

62 Latour, Almar and Drucker, Jesse, “Strains Between Telecom Giants Threaten Big Cellphone Venture,” *The Wall Street Journal*, July 15, 2003, at 1

1 If Verizon saw wireless as a true “substitute” for wireline service, there would be no incentive
2 for customers to “bundle” wireline and wireless service together, since any price for wireline
3 phone service above the price of a customer’s wireless plan would bring no marginal benefit to
4 the customer.

5

6 46 Verizon is not the only BOC bundling wireline with wireless. SBC and BellSouth both
7 offer numerous bundles of wireline and wireless service. In addition, SBC and BellSouth, the
8 owners of Cingular wireless, recently announced a bundled offer of wireless and wireline giving
9 the customer the ability to “share” a single pool of minutes, between their wireless and wireline
10 phone. In announcing this plan, BellSouth noted customer preference for wireless long distance
11 pricing, but also the major drawback to wireless phone use— service quality

12

13 The service is designed for people who use the large number of night and
14 weekend minutes typically found in wireless plans to make long distance calls
15 from home. With the MinuteShare service, they will be able to take advantage
16 of these minutes to make long distance calls while enjoying the clarity and
17 quality of their home wireline phone.⁶³

18

19 BellSouth’s press release and MinuteShare service recognizes the quality differences noted by
20 the FCC between wireless and wireline, and thus that the two services are not yet substitutes.

21

63 BellSouth Press Release, “SBC, BellSouth and Cingular join forces to erase distinction between wireline and wireless calls, offering shared bucket of minutes,” June 5, 2003.

1 *VoIP/Data Platforms*
2

3 47 The rise of data technologies, especially VoIP, e-mail and instant messaging, has led the
4 BOCs to claim that these services offer a substitute for long distance service, and therefore
5 protection against BOC misconduct. However, in the vast majority of cases, consumer use of
6 these services is completely dependent upon BOC bottleneck services (and therefore BOC
7 bottleneck pricing). To utilize either e-mail or instant messaging, a consumer must purchase
8 either dial-up or broadband internet service. According to Nielson research, approximately 64%
9 of users access the internet through narrowband (dial-up) connections, while 36% utilize high
10 speed connections.⁶⁴ Assuming that internet users utilize BOC facilities in the same proportion
11 as the general residential access lines (96.6%), BOCs control the underlying facilities for some
12 61.8% of dial-up users. The FCC reports that DSL accounts for approximately 33% of all
13 broadband users, and “other wireline” services account for 6%.⁶⁵ On this basis, nearly 76% of
14 all residential internet users (39% x 36% + 61.8%) rely ultimately upon the BOC bottleneck for
15 internet access. This overwhelming reliance upon the wireline facilities of the BOC belies the
16 BOC claim that these same services are *substitutes* for the BOC’s facilities.

17
18 48 Broadband internet access theoretically offers the additional substitute of VoIP.
19 However, as noted by Deutsche Bank, “the threat from VoIP has been a little bit overblown and

64 <http://www.nielsen-netratings.com/news.jsp>

65 FCC, IATD, *High Speed Services for Internet Access Status as of December 31, 2002*, at Table 1

1 we certainly do not see a step-change in industry dynamics — at least for the next five years.”⁶⁶
2 Additionally, BOC pricing strategies for high speed access ensure that VoIP is an unattractive
3 substitute to traditional wireline service. The BOCs require that a customer ordering DSL *also*
4 purchase local phone service, so any VoIP service provided to a customer who is served over
5 DSL will be entirely redundant to the BOC’s dial tone line service. This requirement severely
6 limits the ability for VoIP providers to compete, severely limiting their utility as a “substitute” to
7 wireline service.

8
9 **Under the current cost allocation rules, BOCs have the incentive and ability to engage in**
10 **cost shifting between their local and long distance operations.**

11
12 49 Unlike AT&T in 1995, the BOCs *are not stand-alone long distance companies*. Unlike
13 the post divestiture AT&T, the BOCs’ integrated provision of local and long distance service
14 (especially while access charges remain priced at multiples of costs) affords them with a unique
15 advantage over competing stand-alone IXCs. As I discussed at length in my June 30
16 Declaration, BOCs are able to effectively ignore the imputation of access charges, gain signifi-
17 cant market share for a tiny fraction of the sales and marketing costs confronting stand-alone
18 rivals by exploiting their legacy relationships with monopoly local service customers, and avoid
19 significant billing and customer care costs by “piggy-backing” them onto existing BOC ILEC
20 functions and assigning virtually all joint local/long distance costs to their monopoly local
21 service operations.

66 Deutsche Bank Study, at 67

1 50. Indeed, although the BOCs argue that they are entitled to pursue and benefit from
2 potential economies of scope by providing local and long distance services on an integrated
3 basis, they are distinctly *not* entitled to confer 100% (or close to 100%) of those integration gains
4 upon their competitive long distance operations. In fact, such treatment is expressly prohibited
5 by Part 64 of the FCC's Rules, which require an apportionment of costs between regulated and
6 nonregulated ILEC services on the basis of fully distributed cost. Section 272(b)(5) requires
7 "arm's length" transactions between a BOC and its long distance affiliate, and thus supersedes
8 the Part 64 cost allocation as long as the Section 272(a) separate affiliate requirement remains in
9 effect. However, once that requirement has been allowed to sunset and the BOC proceeds to
10 fully integrate and absorb its long distance business into its monopoly local service operations,
11 strict enforcement of Part 64, only possible with the detailed cost support data required by
12 dominant carrier regulation, will be the only means by which the Commission can assure that the
13 BOC is not using its legacy monopoly local service operations to support and to cross-subsidize
14 its competitive long distance business.

15
16 51. In its comments, Qwest relies upon the requirements of Part 64 to prevent cost
17 misallocation.⁶⁷ However, without dominant carrier regulation of the BOCs' long distance
18 services, there is no practical means by which the Commission will be able to detect, on an
19 ongoing basis, noncompliance with Part 64. If customer service representatives, customer
20 databases, operations support systems, billing and collection systems, and other BOC ILEC

67. Qwest Comments, at p. 19-20.

1 resources are utilized jointly to provide local and long distance services, the Commission's cost
2 allocation rules would require that the joint costs of those resources be spread ratably across both
3 service categories, rather than being made available, without charge, to the nonregulated
4 business activity

5
6 52 Specifically, subpart I of Part 64 requires carriers to separate the costs of regulated
7 activities from those of nonregulated activities, and sets forth broad rules for allocating such
8 costs. The cost allocation rules also provide that a telecommunications carrier may not use
9 services that are not competitive to subsidize services subject to competition.⁶⁸ However, even if
10 one could assume the BOCs' complete technical compliance with the principles set forth at Part
11 64, these rules leave substantial room for improper and anticompetitive allocation of costs when-
12 ever regulated and nonregulated activities take place on a fully integrated basis

13
14 53 Carriers are required to assign costs directly to regulated or nonregulated activities
15 "whenever possible."⁶⁹ The Commission's rules recognize, however, that not all of a carrier's
16 costs are directly assignable. Under Part 64, all costs not directly assignable are considered
17 "common" costs. The rules require the carrier to group common costs into "homogeneous cost
18 categories" and then assign each cost category based upon a "hierarchy" of cost allocation
19 principles.

68 47 CFR § 64.901(c)

69 47 CFR § 64.901(b)(2)

1 (i) Where possible, the carrier must allocate a category of common costs “based upon
2 direct analysis of the origin” of those particular costs

3

4 (ii) If this is not possible, the allocation shall be based upon an “indirect, cost-causative
5 linkage to another cost category (or group of cost categories) for which a direct
6 assignment or allocation is available ”

7

8 (iii) If neither of the first two methods are feasible, then the carrier must use “a general
9 allocator computed by using the ratio of all expenses directly assigned or attributed
10 to regulated and nonregulated activities.”

11

12 If these rules are not vigorously enforced, they leave the BOCs with significant discretion that
13 can be used to shift costs from its long distance operations to its regulated activities.

14

15 54 Moreover, although Part 64 requires the ILECs to provide a more detailed explanation
16 of their actual cost allocations in their cost allocation manuals (“CAMs”), there has been little
17 scrutiny of the CAMs, and there would be little or no scrutiny at all over a “non-dominant” long
18 distance operation. The biennial Section 272 audits are supposed to identify any cost accounting
19 abuses, but once the Section 272 affiliate ceases to exist as a separate corporate entity, the
20 effectiveness of biennial audits -- if any — will be severely undermined

21

1 55 In any event, an “audit” must *by its very nature* take place *after-the-fact*. At best, it can
2 detect accounting irregularities that have already taken place, but it cannot be relied upon as a
3 means for *preventing* them from occurring to begin with. By the time an after-the-fact audit is
4 completed and its results analyzed and adjudicated, unlawful misallocations and cross-
5 subsidizations may persist for a number of *years* before remedial action is taken.

6
7 56 As dominant carriers, BOCs would be required to file tariffs and to supply the
8 Commission with cost data in support thereof. This cost support data would allow the
9 Commission and competitors to scrutinize the Part 64 allocations on a more granular level than
10 available in the high level ARMIS filings. As currently filed, ARMIS cost allocation data
11 provides no data disaggregated enough for scrutiny of allocated long distance costs. In addition,
12 the aggregate nature of the Part 64 data currently provided makes it impossible to compare the
13 allocation of costs associated with the provision of long distance service to the actual long
14 distance plans offered. The only way for the Commission to determine if the properly allocated
15 costs for long distance services provided by the BOCs are less than the price charged is with
16 granular, *rate plan specific* cost support documents and tariffs filed on a minimum of 15 days’
17 notice as required by dominant carrier regulation. Through this detailed cost support, interested
18 parties would have an opportunity to protest an unlawful tariff and seek its suspension and
19 investigation by the Commission. Among other things, the BOC would be *required* to
20 demonstrate that, on a service by service basis, such tariffs comply with Part 64 cost allocation
21 rules and other nondiscrimination provisions of the *1996 Act*.

22

1 **BOC claims that price caps on local services remove the incentive for the BOCs to shift**
2 **costs ignore the reality of state price cap plans.**
3

4 57 Each of the BOCs and Profs. Carlton *et al.* each claim that the application of price cap
5 formulas “lessen or eliminate the relationship between an ILEC’s reported costs and the prices it
6 can charge for regulated services.”⁷⁰ SBC notes the finding made by this commission regarding
7 the effect of price caps. According to SBC

8
9 Concerns about cross subsidization are a relic from the past when BOCs were
10 under rate of return regulation, and, to a lesser extent, price caps with sharing
11 regulation. Thus, in the *Non-Accounting Safeguards Order*, the commission
12 stated that the BOC may have an incentive to allocate improperly to its
13 regulated core business costs that would be attributable to its competitive
14 ventures ‘if the BOC is regulated under rate of return regulation, a price caps
15 structure with sharing (either for interstate or intrastate services), a price caps
16 scheme that adjusts the X-factor periodically based on changes in industry
17 productivity, or if any revenues it is allowed to recover are based on costs
18 recorded in regulated books for accounts.’ None of those circumstances is
19 present today, when BOCs are generally regulated under a pure price cap
20 regime (without sharing).⁷¹
21

22 BellSouth takes this a step further and claims that, as a result of price caps, not only is dominant
23 carrier regulation unnecessary, but so are the Part 64 allocation requirements discussed above.⁷²

24 BellSouth claims that Long Distance should be a “regulated” entity for cost allocation purposes,

70 Carlton *et al.*, at para 66, SBC Comments, at 45; Verizon Comments, at 19; BellSouth
Comments, at 20, Qwest Comments, at 15

71. SBC Comments, at 45

72. BellSouth Comments, at 21

1 removing the need to allocate costs between local and long distance. That, of course, would
2 eliminate any requirement for a BOC to allocate costs as between local and long distance, and
3 make detection of deliberate misallocation virtually impossible to the extent that the remaining
4 cost accounting requirements, set out at Part 32 of the Commission's rules, do not contemplate
5 any detailed service-by-service cost accounting or reporting.

6

7 58 In fact, BOCs are often regulated in ways that the Commission has noted give incen-
8 tives to misallocate costs. Seven states currently have some version of Rate of Return (or mixed
9 rate of return and price cap) regulation.⁷³ An additional eight states are either currently
10 reviewing their Price Cap plans, have price cap plans that come up for review periodically, or
11 have plans that will expire (and thus provoke review) within the next five years.⁷⁴ Even where
12 no formal schedule for price cap review proceedings has been established, ILECs may nonethe-
13 less petition for a review, modification, or even elimination of price cap regulation in the event
14 that an earnings deficiency arises for whatever reason, including for example, the misallocation
15 of costs of competitive services into the monopoly service category. I discussed the impact of
16 this treatment of price caps, and its inability to forestall cost shifting, at length in my June 30,
17 2003 Declaration.⁷⁵ In order for price cap regulation to prevent or even limit a BOC's ability to
18 engage in cross-subsidization of competitive services by supranormal profits generated from

73. Alaska, Arizona, Hawaii, New Hampshire, and Washington

74. California, Colorado, Minnesota, Nevada, New Mexico, South Dakota, Texas and Utah

75. Selwyn June 30, 2003 Declaration, at paras. 97-103

1 monopoly services, the price adjustment mechanism would itself need to be properly specified
2 so as to limit both the BOC's ability to earn supranormal profits (and thereby acquire the
3 "engine" for cross-subsidization), and the BOC's ability to seek extraordinary rate relief or a
4 major revision in the price adjustment mechanism in the event that, having shifted costs of its
5 competitive operations to its monopoly services, it sustains an earnings deficiency in the mono-
6 poly service category. In some states, BOCs have been permitted to remove highly profitable
7 yet largely noncompetitive services from their price cap plans (e.g., the yellow pages directory
8 publishing operations) and have then sought reductions in or elimination of the productivity
9 offset ("X") factor as a result of the (seemingly) reduced level of earnings.⁷⁶

10

11 **BOC claims that "predation is rarely a profitable strategy" are not supported by modern**
12 **economic theory and assume conditions that are demonstrably absent in the case of the**
13 **BOCs.**

14

15 59 Professor Carlton *et al.* assert that "[t]he foremost reason [for the Commission not to be
16 concerned with the ILECs incentive or ability to engage in a price squeeze] is that it is widely
17 recognized that predation is rarely a profitable strategy."⁷⁷ Note that the only specific authority
18 advanced by Carlton *et al.* in support of their "widely recognized" assertion is *their own prior*

76 In 1997, then-Bell Atlantic was permitted by the Pennsylvania PUC to shift its Pennsylvania directory publishing activity out of regulation, and in so doing reduced its reported intrastate rate of return from 16.07% in 1996 to 11.02% in 1997 (from Verizon 10-K Annual Reports). Verizon is currently asking the Pennsylvania legislature to eliminate altogether the X-factor from its price cap plan. Pennsylvania Telephone Association draft legislation, House Bill 30 Section 3015.

77 Carlton *et al.*, at para. 54.

1 writing⁷⁸ However, a review of recent economic literature by authors other than the BOCs'
2 Declarants flatly contradicts this claim.⁷⁹ In fact, Carlton *et al* seem to be relying upon older
3 economic studies and upon the courts' interpretation of those studies, conveniently ignoring new
4 evidence to the contrary.

5

6 60 Those courts have relied upon economic theory, now 25 years old, to make judgments
7 regarding the supposed rationality of firms' actions, relying upon early literature, such as Bork
8 (1978) and McGee (1958, 1980), that found predatory pricing to be irrational economic
9 behavior.⁸⁰

10

11 61 However, that notion of "irrationality" is certainly not universally shared outside of
12 Chicago. Klevorick argues, for example, that the courts have entirely ignored the newer equilib-
13 rium (or game theoretic) models. In fact, Bolton, Brodley and Riordan wrote recently that

78. Carlton *et al*, at footnote 51, citing *Modern Industrial Organization* by D. Carlton and J. Perloff.

79. A body of economic theory challenging the notion that predation is rare has been developed over the past twenty years. This work includes, but is not limited to, the following: Patrick Bolton, Joseph F. Brodley and Michael H. Riordan, "Predatory Pricing: Strategic Theory and Legal Policy," The Boston University School of Law Working Paper Series, Working Paper 99-5 (January 29, 2000) (also published in *Georgetown Law Journal* 88 2239-2330), Aaron S. Edlin, "Stopping Above-Cost Predatory Pricing," *Yale Law Journal* 111 (January 2002): 941-991, Alvin K. Klevorick, "The Current State of the Law and Economics of Predatory Pricing," 83 *American Economic Review* (AEA Papers and Proceedings 1993) 162-167, Garth Saloner, "Predation, mergers, and incomplete information," *Rand Journal of Economics*, Vol. 18, No. 2 (Summer 1987) 165-186.

80. Klevorick, at 166.

1 modern economic analysis has developed coherent theories of predation,
2 contravening earlier economic writing claiming that predatory pricing conduct
3 is irrational. More than that, *it is now the consensus view in modern eco-*
4 *nomics that predatory pricing can be a successful and fully rational business*
5 *strategy*, and we know of no major economic article in the last 30 years that
6 has claimed otherwise. In addition, several sophisticated empirical case
7 studies have confirmed the use of predatory pricing strategies. But the courts
8 have failed to incorporate the modern writing into judicial decisions, relying
9 instead on earlier theory no longer generally accepted.⁸¹
10

11 Economists have developed new theories beginning in the early 1980s challenging the old
12 Chicago School views on predatory pricing. These new theories coincided with the evolution of
13 modern game theory, which has allowed economists to develop more complex models of firms'
14 behavior in markets.

15 This new body of research challenges the static framework of perfect
16 information on which McGee [and thus the Court] had relied. The new
17 analysis explains predatory pricing in a dynamic world of imperfect and
18 asymmetric information in which strategic conduct can be profitable.⁸²
19
20

81 Bolton *et al.*, at 1. At footnote 2, the authors state: "Prior papers suggesting judicial evaluation of predatory pricing in light of modern strategic theory include Alvin K. Klevorick, *The Current State of the Law and Economics of Predatory Pricing*, 83 *Am. Econ. Rev.* 162 (Papers & Proceedings, 1993), Janusz A. Ordover & Garth Saloner, *Predation, Monopolization, and Antitrust*, in 1 *Handbook of Industrial Organization* 537 (Richard Schmalensee & Robert D. Willig, eds. 1989) (citing earlier work by Oliver Williamson and others); Richard Craswell & Mark R. Ratrik, *Predatory Pricing Theory Applied: The Case of Supermarkets vs. Warehouse Stores*, 36 *Western Reserve L. Rev.* 1, 34-47 (1985)." See, also, Klevorick, at 162.

82 Bolton *et al.*, at 10.

1 These *new* theories explain why predatory pricing is still observed in the “real world” and why it
2 remains a “rational, profit maximizing strategy.”⁸³

3

4 62 The Carlton *et al* Chicago School position regarding predatory pricing is founded upon
5 the concept of perfect information — an important theoretical concept, but one that often fails to
6 capture the realities of the market. The Chicago School theories fail where asymmetric informa-
7 tion has a role to play. As Saloner notes, there is a “large and growing literature that illustrates
8 that when one abandons the assumption of complete information, there are numerous ways in
9 which rational predatory pricing can arise.”⁸⁴ None of the new writings would suggest that the
10 Chicago School view is incorrect in a simple market, but “in more complex, realistic market
11 situations, such as those with imperfect information about costs or about market toughness,
12 aggressive pricing can yield significant long-run benefits to the incumbent firm.”⁸⁵

13

14 63 Critics of the courts’ adherence to the Chicago School theory regarding predatory
15 pricing argue that the continued reliance upon the work of McGee and Bork is due to the

83 Bolton *et al*, at 10-11, citing Janusz A. Ordover & Garth Saloner, “Predation, Monopolization, and Antitrust,” in *Handbook of Industrial Organization* (Richard Schmalensee & Robert D. Willig, eds. 1989)

84 Saloner, at 183.

85 Edlin, at 955-956

1 complex nature of the newer economic theories⁸⁶ The fact remains that the statement by Carlton
2 *et al* that there exists wide recognition that “successful predation is rare” is simply unfounded
3 Indeed, a recent ruling by the Tenth Circuit underscores this point.

4
5 Recent scholarship has challenged the notion that predatory pricing schemes
6 are implausible and irrational. See, e.g., Patrick Bolton et al., *Predatory*
7 *Pricing: Strategic Theory and Legal Policy*, 88 *Geo. L.J.* 2239, 2241 (2000)
8 (“Modern economic analysis has developed coherent theories of predation that
9 contravene earlier economic writing claiming that predatory pricing conduct is
10 irrational.”) Post-Chicago economists have theorized that price predation is
11 not only plausible, but profitable, especially in a multi-market context where
12 predation can occur in one market and recoupment can occur rapidly in other
13 markets. See Baker, *supra*, at 590.

14
15 Although this court approaches the matter with caution, we do not do so with
16 the incredulity that once prevailed.⁸⁷

17

18 64 A central feature of the Carlton *et al* assessment that predation would not be profitable
19 for the BOCs is rooted in the patently incorrect *assumption* that in order to engage in predatory
20 pricing the BOCs would have to sacrifice *current* profits on the expectation that these short-term
21 losses would be more than made up through future supracompetitive profits that would become
22 available once the BOCs’ rivals had exited the market. That view, however, is rooted in the
23 patently incorrect *assumption* that the BOCs would be unable to recover their current losses from

86 Edln, at 956; Bolton *et al*, at 12

87 *US v. AMR*, ___ F.3d ___, 2003-3 Trade Cases ¶74,078 (10th Cir. 2003), slip. op. at 10-11

1 predation through higher rates in the future, because were they to attempt to raise prices once
2 rivals exited the market, the rivals would immediately reenter and push BOC prices down. This
3 theory would require, at a minimum, (a) that rivals would immediately reenter the market (after
4 having exited it) as soon as the BOCs attempted to increase prices in the future, thereby fore-
5 closing post-predation profit recoupment, or (b) that the BOCs have no ability to *cross-subsidize*
6 current predatory pricing initiatives with excess profits generated by other BOC services. In
7 reality, of course, *neither one of these prerequisite conditions exists.*

8
9 65 As I have discussed at length in my June 30, 2003 Declaration, BOCs have sufficient
10 pricing flexibility within existing price cap regimes to easily finance a predation strategy *out of*
11 *current profits from services over which they maintain near-absolute monopolies.* These
12 include, in particular, switched and special access services that the BOCs furnish to the very
13 same rival carriers that are the targets of the BOCs' predatory pricing initiatives. Indeed, the
14 ability to raise their rivals' costs while using the excess profits generated thereby to fund below-
15 cost pricing of competitive services works to subject nonaffiliated rivals to a *double-barreled*
16 attack, where the rivals' own payments to the BOC for monopoly access services are then used
17 by the BOC to create the price squeeze

18
19 66 The second prong of the Carlton *et al* unprofitability-of-predation theory requires that
20 BOC rivals, once having been pushed out of the market by an effective BOC price squeeze
21 strategy, would nevertheless rapidly reenter the long distance market were the BOCs to raise
22 long distance prices. This utterly fanciful notion ignores the realities of the capital markets, the

1 formidable barriers that a reentry attempt would confront with respect to customer acquisition,
2 and actual IXC experience in acquiring customers immediately following implementation of
3 equal access where the then-incumbent, AT&T, had *none* of the local service market power
4 advantages that the BOCs possess today

5
6 67 For starters, in light of recent experience with telecommunications start-up ventures,
7 there is almost no likelihood that investment capital would be made available to finance any
8 consequential IXC reentry initiative. In addition to the enormous customer acquisition costs that
9 any reentry attempt would necessarily face, the threat of a repetition of a BOC predation strategy
10 following such reentry would be more than sufficient to chill any serious investor interest in such
11 a venture. Indeed, this is precisely the sort of game theory perspective that Prof. Carlton and his
12 Chicago School colleagues overlook when claiming that successful predation would be
13 impossible. Moreover, by limiting their focus to the seemingly abundant interexchange network
14 capacity that presently exists, Carlton *et al.* ignore the much larger component of reentry costs —
15 the *reacquisition of customers who will have switched to the BOC* for their long distance service
16 and the continuing obstacles that an IXC that is not also offering local exchange service would
17 face when competing with BOC bundled local/long distance packages. As I noted at para. 8
18 *supra*, in each of the states in which BOC long distance entry had occurred, the BOC had
19 succeeded in capturing more market share in just 24 months than all of the non-AT&T inter-
20 exchange carriers combined had been able to take from AT&T after *ten years* following the full
21 implementation of equal access. Once the BOCs have forced their nonaffiliated rivals out of the
22 residential/small business long distance market, those firms will have no realistic ability to

1 rapidly and successfully reenter the market in response to increased BOC long distance prices,
2 and will be unlikely to undertake any such reentry attempt. As such, the BOCs will be able to
3 recoup profits foregone while engaging in predation once they have succeeded in forcing their
4 competitors out of the market.

5

6 **BOC claims that they are not engaging in predation and that they could not engage in**
7 **predation are also belied by the very same investment analyst reports that Prof. Carlton *et***
8 ***al* cite as authority for several of their other contentions.**

9

10 68 Prof. Carlton *et al* additionally claim that predatory strategy would not succeed in the
11 long distance market as a result of the presence of several large, established rivals, and the
12 available capacity of long distance networks in theory allows new competitors to enter the
13 market in the even of a price increase. However, despite this theoretical assertion that predation
14 is unlikely, Prof. Carlton *et al* chose to ignore evidence presented in the Deutsche Bank study
15 that BOCs are indeed engaging in predation with the expectation that their size and local
16 customer base will allow them to kill their competition. As Deutsche Bank notes, “. . . neither
17 UNE providers, independent wireless, DSL operators nor cable MSOs have anything
18 approaching the RBOCs’ financial capacity or customer reach. In the game of ‘last man
19 standing,’ the RBOCs will be that man.”⁸⁸

20

21 69 Deutsche Bank concludes that BOCs are exerting significant average revenue per
22 minute pressure with their current pricing plans. The analysts conclude, “We see no end to this

88 Deutsche Bank Study, at 3

1 pricing strategy since the RBOCs are playing a market share, rather than revenue-maximization,
2 game.”⁸⁹ Under the Carlton theory that predation is an unlikely tactic for BOCs, a BOC would
3 never “play a market share, rather than revenue maximization game.” The only reason for the
4 BOCs to price their services at a price that is less than revenue maximizing would be if they
5 believed that the increased market share that would result from their “buy-in” pricing strategy
6 could be sustained after rivals exited, and did not reenter, the long distance market, affording the
7 BOCs ample opportunity to recoup any profits that they may currently be foregoing

8

9 **Elimination of structural separation requirements would vastly enhance the BOCs’ ability**
10 **to engage in price and non-price discrimination against rivals with respect to access to the**
11 **BOCs’ monopoly local networks.**

12

13 70 The BOCs and their Declarants argue that the BOCs’ *ability* to engage in cost shifting,
14 price and non-price discrimination would not be affected by the elimination of dominant carrier
15 regulation. For example, Prof. Carlton *et al.* suggest that

16

17 The incentive and ability for ILECs to engage in non-price discrimination in providing
18 rival long distance carriers access to local telephone networks *depends on the ability of*
19 *long distance firms and regulators to detect such actions as well as the penalties that*
20 *result if discrimination is detected.* Expiration of the structural separation requirements,
21 however, affects only how ILECs structure their internal operations, not their incentive
22 or ability to engage in non-price discrimination.⁹⁰

23

89 Deutsche Bank Study, at 52

90 Carlton *et al.*, at para. 46, emphasis supplied

1 As the Professor sees it, the BOCs's ability to engage in non-price discrimination against their
2 rivals rests upon the extent to which they can successfully follow the "eleventh commandment"
3 — i.e., "*thou shalt not get caught*." What Prof. Carlton and his colleagues seem to be
4 suggesting, in fact, is that the BOCs *can be counted upon to engage in non-price discrimination*
5 so long as such conduct can go undetected *and*, if detected, so long as the penalties that would
6 then be imposed are small relative to the potential economic gains that might result from such
7 conduct.

8
9 71. It's hard to find fault with this reasoning. Acting in their own self-interest, the BOCs
10 will persist in "pushing the envelope" until blocked. Where we seem to disagree is how quickly
11 that will occur and, more specifically in the context of this proceeding, whether elimination of
12 dominant carrier regulation will affect the likelihood that such conduct would be detected and, if
13 so, the likelihood that the penalties will be sufficiently great as to deter such conduct in the first
14 place.

15
16 72. Of course, no one has ever suggested that dominant carrier regulation of BOC long
17 distance services will preclude or foreclose BOC attempts to discriminate against their rivals. To
18 the contrary, such conduct persists *despite* the existence of regulations that are expressly
19 designed to prevent it. Regulation does, however, facilitate detection, and provides the
20 mechanism for remedial measures if such conduct *is* detected. I described above, detailed cost
21 support data, including the allocation of cost between local and long distance services and
22 associating costs with the appropriate end-user service are crucial to the detection of cost-

1 shifting, the enforcement of imputation requirements, and to avoid predation. Indeed, the only
2 condition under which the removal of regulation would have no impact upon a BOC's ability to
3 engage in anticompetitive acts is if regulation is utterly incapable of constraining such conduct to
4 begin with. Under that reasoning, if the local police are unable to prevent all crime or to solve
5 all crimes that do take place, then one might as well do without the police altogether. But if that
6 is actually what Carlton *et al* are contending, then the solution is *not* to abandon regulation, but
7 to strengthen it so that it can do the job that it was designed to do

8
9 73 As I have discussed at considerable length in my June 30, 2003 Declaration, BOCs can
10 and do engage in both price and non-price discrimination with respect to rival IXCs.⁹¹ Where
11 imputation rules are present - - the case with respect to many intraLATA toll services that are
12 provided by the BOC on a fully integrated basis with its local services — they are frequently
13 *evaded* (e.g., by combining multiple services within the same imputation “test”), *avoided* (by
14 imputing only the specific “access services” that the BOC itself utilizes when providing its
15 competitive intraLATA toll service, which may be few or none), and *ignored* for purposes of
16 setting the applicable retail price for the toll service. But at least there is an “on the books”
17 requirement that an imputation test be made and that it be provided to the state commission as an
18 integral component of the tariffing and ratesetting processes

19

91 Selwyn June 30, 2003 Declaration, at paras 74-103.

1 74 In principle, of course, the BOCs' Section 272 long distance affiliates are also subject to
2 an imputation requirement. Section 272(e)(3) provides that.

3
4 A Bell operating company and an affiliate that is subject to the requirements of
5 section 251(c) shall charge the affiliate described in subsection (a), or
6 impute to itself (if using the access for its provision of its own services), an
7 amount for access to its telephone exchange service and exchange access that
8 is no less than the amount charged to any unaffiliated interexchange carriers
9 for such service
10

11 The statute is far from clear, and the Commission has never defined, precisely how the "amount
12 for access to [the BOC's] telephone exchange service and exchange access" is to be determined
13

14 75 Where the retail long distance service is provided by a separate Section 272 affiliate
15 subject to the Section 272(b)(1) "operate independently" requirement, the affiliate must purchase
16 *exactly* the same kinds of access services that a nonaffiliated IXC would be required to purchase
17 in order to provide its retail services. Hence, so long as the separate affiliate requirements (such
18 as Section 272(b)(5)) and "operate independently" requirements remain in effect, at least with
19 respect to access services, the affiliate long distance entity and nonaffiliated IXCs each deal with
20 the BOC's ILEC entity for access services on a roughly equivalent basis. That will not be the
21 case, however, once full integration is allowed.

22

23 76 We can look to the situation relating to *intraLATA* toll services as indicative of what
24 might arise were the BOCs permitted to provide long distance on a fully integrated basis. In
25 fact, precisely this type of integration exists today, with respect to *intraLATA* toll services. With

1 respect to imputation, BOCs have argued that they are only obligated to impute the tariff rate for
2 the access services *that they themselves utilize* in providing the retail toll service, and
3 specifically *not* the suite of access services that a rival nonaffiliated IXC would utilize when
4 providing intraLATA services to its retail customers. And because their local and intraLATA
5 toll networks are operated on a fully integrated basis, the BOCs frequently do not use the same,
6 or perhaps *any*, of the specific access services and functions that their nonaffiliated rivals are
7 forced to utilize. For example, when an intraLATA call originated by a BOC end user is routed
8 to an IXC, it will typically be routed from the originating end office via common transport to a
9 BOC access tandem, then via dedicated transport to the IXC's Point of Presence ("POP") via
10 dedicated transport, then back via dedicated transport to another (perhaps even to the same) BOC
11 access tandem, and then over common transport to the terminating BOC end office (see Figure 1
12 below). If that same call is provided end-to-end by the BOC, it will either be routed via a direct
13 end office trunk ("DEOT") between the originating and terminating end offices without any
14 tandem routing at all, or *at most* will be routed via one local tandem switch (see Figure 2). In
15 some cases, the two exchanges at the ends of the toll call may even be served by the very same
16 end office switch, in which event the call is completed entirely on an intraswitch basis, without
17 any common or dedicated interoffice transport or interoffice switching (see Figure 3).⁹²

92. This might occur, for example, where the central office switches serving the two exchanges have been consolidated into a single switch entity, while the preexisting exchange boundaries and local calling areas remained intact. For example, Lewiston and Farmington, Maine, some 45 miles apart, are both served by the same Verizon host central office switch, LSTNMEASDS0 physically located in Lewiston. Calls between these two communities are subject to intraLATA toll rate treatment.

1 77. If the BOC does not itself utilize the same access services and access functions that it
2 provides (at above-cost prices) to its non-integrated, non-affiliated rivals and is only required to
3 impute to itself the equivalent tariff price for the services and functions that it actually uses (or is
4 selectively exempted from imputation altogether), the rival carriers can and will be forced into a
5 price squeeze if the price that they pay for the access functions that they use exceeds the amount
6 that the BOC is required to impute

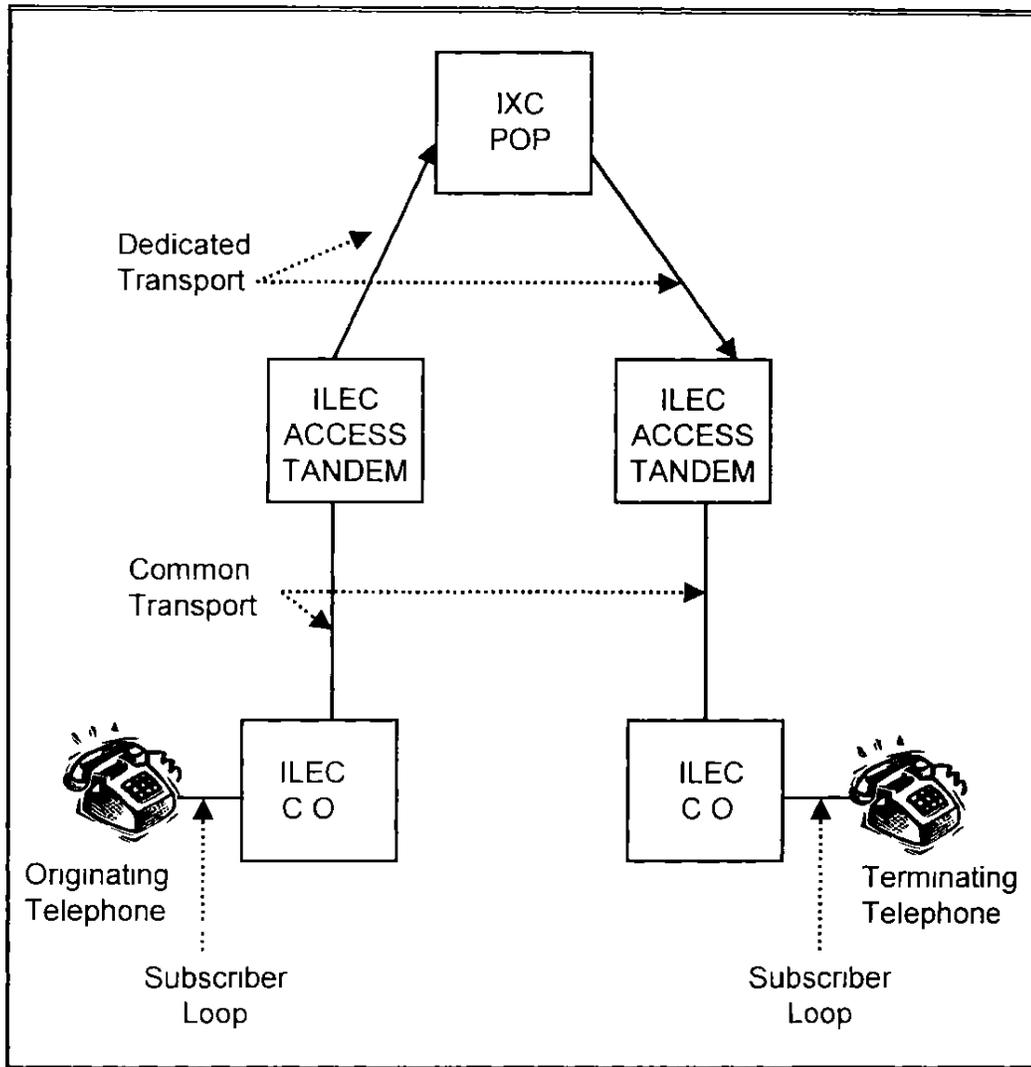


Figure 1 Routing of intraLATA toll call via IXC.

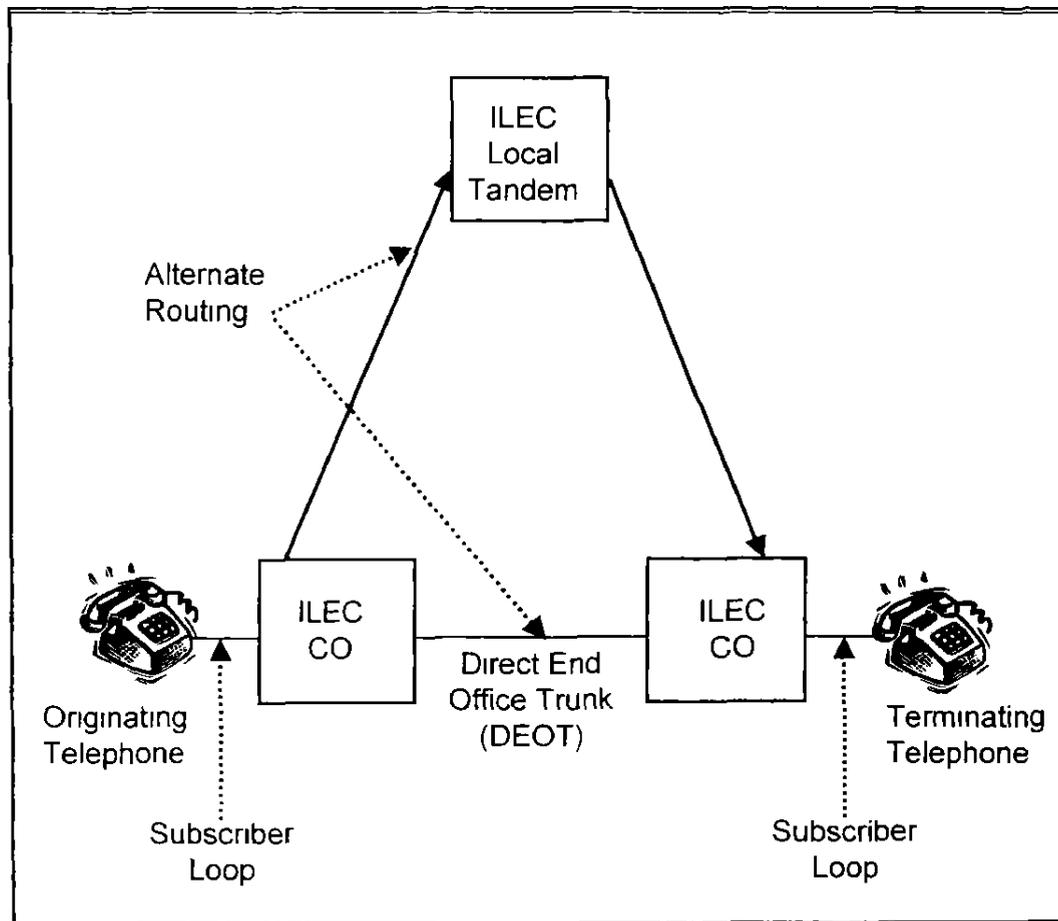


Figure 2 Routing of intraLATA toll call carried end-to-end by ILEC.

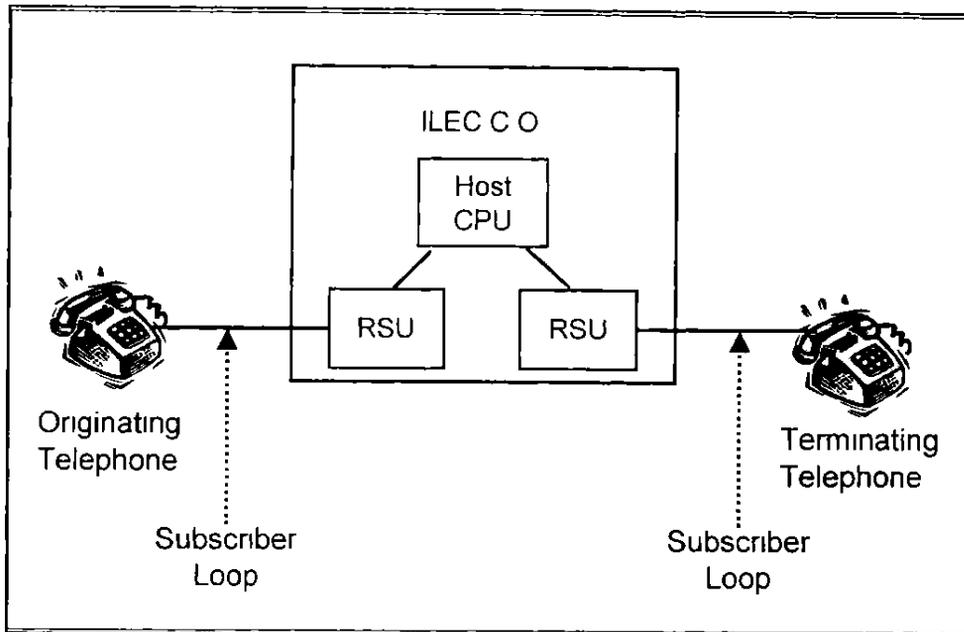


Figure 3 Routing of intraLATA toll call carried end-to-end by ILEC on an intraswitch basis

1 78 Finally, even where the BOC's retail long distance price nominally "covers" the sum of
2 access charges plus incremental non-access costs, a price squeeze may still result if the incre-
3 mental non-access costs are determined by treating all joint costs as non-incremental to the long
4 distance operation

5

6 **Conclusion**

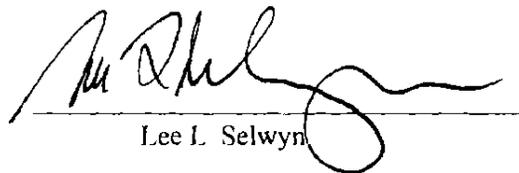
7

8 79 In its Comments, Verizon refers to the Commission's conclusion in its *LEC*
9 *Classification Order* that ". . . dominant carrier regulation . . . can stifle price competition and
10 marketing innovation when applied to a competitive industry."⁹³ But the Commission also
11 determined, in view of the separate affiliate requirements and safeguards of Section 272 and the
12 near-zero long distance market share then being held by the BOCs, that dominant carrier regu-
13 lation was *unnecessary* and that its burdens outweighed its benefits. But experience has taught
14 otherwise. BOCs and other ILECs continue to overwhelmingly dominate the local exchange
15 service market, providing the underlying facilities for more than 96.6% of all access lines in the
16 nation. Since attaining in-region long distance entry, BOCs have amassed market share at an
17 unprecedented rate, rapidly eclipsing competition in the long distance market while maintaining
18 their continued dominance and market power with respect to local services. Whatever conclu-
19 sions the Commission may have reached six years ago must be revisited and revised in light of
20 conditions "on the ground" today. The BOCs' Declarants herein have readily *conceded* that
21 BOCs have both the incentive and the ability to engage in anticompetitive conduct so long as

93 Verizon Comments at 2, citing *LEC Classification Order*, at paras. 89-90

1 they do not get caught doing so. The BOCs' Declarants have advanced obsolete theories
2 regarding predatory pricing that are premised upon theoretical "perfect" information flows and
3 reentry opportunities were BOC predation successful in forcing rivals out of the long distance
4 market. And finally, while the BOCs speak of dominant carrier regulation as "adversely
5 affecting competition," they have failed utterly to demonstrate any factual basis for that
6 speculation and, indeed, have failed to refute the opposite conclusion. Regulation of the BOCs
7 as dominant carriers is critically important if *any* meaningful competition is to persist in the
8 nation's local and long distance telecommunications sectors, and the gains from continued
9 competition are easily worth whatever nominal "burdens" may arise as a result

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


Lee L. Selwyn