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June 9, 2004

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W., Room TWB-204
Washington, DC 20554

Re: Ex parte, *Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, CC Docket Nos. 00-175, 01-337, 02-33

Dear Ms. Dortch:

On Tuesday, June 8, 2004, Lee Selwyn, James Talbot and the undersigned, representing AT&T, met with William Dever, Michael Carowitz, William Kehoe, Jon Minkoff, William Cox, Kimberly Jackson, Alicia Dunnigan and Cliff Rand of the Wireline Competition Bureau concerning the above-captioned proceeding. We discussed the growth of BOC long distance market shares and the need for service specific imputation safeguards for BOC in-region long distance services, as described by the attached *Ex Parte* Declaration of Lee Selwyn, dated June 8, 2004, which was distributed at the meeting. We also distributed at the meeting a document that examines confidential BOC data filed pursuant to the Commission's Protective Order of December 22, 2003, and that is accordingly designated as Confidential and filed separately under seal. We also referred to the increases in BOC long distance subscribers and the forecast for U.S. broadband IP telephony subscribers shown by the attached excerpts from recent reports.

Respectfully submitted,

cc: M. Carowitz, K. Jackson, W. Cox, W. Kehoe, W. Dever, J. Minkoff, A. Dunnigan, C. Rand

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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

Ex Parte Declaration

of

LEE L. SELWYN

on behalf of

AT&T Corp.

June 8, 2004

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

EX PARTE DECLARATION OF LEE L. SELWYN

Introduction and Summary

Lee L. Selwyn, of lawful age, declares and says as follows:

1. My name is Lee L. Selwyn; I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108. I submitted a Declaration in this matter on June 30, 2003, and a Reply Declaration on July 28, 2003, on behalf of AT&T Corp. ("AT&T").

2. This *ex parte* declaration describes the service-by-service imputation requirements that should be implemented to prevent cross-subsidization when BOCs provide in-region long

1 distance services on an integrated basis – irrespective of whether BOC-provided long distance is
2 regulated as dominant or nondominant. Sample text for an imputation and cost allocation rule
3 that is consistent with these requirements is provided in Appendix 1. My comments herein focus
4 upon two key aspects of an imputation requirement.
5
6 *First*, I explain why BOC integrated long distance services should be required to impute
7 BOC local service functionality and services at their *fair market value*. In an ideal world, all
8 access and tariff services required by nonaffiliated IXCs as inputs to their own long distance
9 offerings would be priced based upon forward looking economic cost, and all *non-tariff*
10 functionality and services that are being used by the BOCs when providing long distance
11 services on an integrated basis would be offered and available to nonaffiliated IXCs on a
12 nondiscriminatory basis *and* at rates based upon forward-looking economic cost. Since
13 none of these conditions apply, the use of a fair market value imputation standard will at
14 least assure that the BOCs derive no competitive advantages as a consequence of their
15 integrated provisioning of monopoly local and competitive long distance services that are
16 not also available to competing nonaffiliated carriers. BOCs are already required by section
17 272(e)(3) (which does not sunset along with other provisions of section 272) to comply with
18 a market value imputation standard with respect to access services (where "fair market
19 value" is, for this purpose, defined as the tariff rate). The same imputation standard should
20 also be applied to non-access tariff services and to any non-tariff BOC local service
21 functionality and services that are used by BOCs in providing long distance services on an
22 integrated basis. Anticompetitive cross-subsidization of integrated BOC long distance

services can be prevented only if those services are required to impute BOC local service functionality and services at fair market value.

Second, I explain why adequate safeguards to prevent cross-subsidization require imputation to be satisfied on *service by service* basis, and I outline the changes in the Commission's Part 64 and cost allocation rules and other changes that are necessary to achieve this result.

Finally, I emphasize that dominant carrier regulation is also required of BOC long distance services provided on an integrated basis, to ensure that BOC long distance prices are fully supported by all imputed and actual costs.

Integration of BOC in-region long distance operations with BOC ILEC entities requires improved imputation safeguards supported by dominant carrier regulation.

3. In an ideal world, rival firms in competitive markets should have equal and equivalent access to all of the principal inputs to the production of their respective products and services; if one such firm happens to wield monopoly control over one or more of these essential inputs, it would have the ability to limit entry and competition in its downstream product market. Sections 251 and 252 of the *Telecommunications Act of 1996* ("*1996 Act*") and the FCC's implementation thereof seek to address this condition, specifically with respect to *local* telecommunications services, by requiring that CLECs be afforded nondiscriminatory access to ILEC network resources at prices based upon forward-looking economic cost. In the case of *long distance* services, if all tariff services required by nonaffiliated IXCs as inputs to their own long

1 distance offerings were priced based upon forward looking economic cost, and if all *non-tariff*
2 functionality and services that are being used by the BOCs when providing long distance
3 services on an integrated basis were also being offered and available to nonaffiliated IXCs on a
4 nondiscriminatory basis *and* at prices based upon forward looking economic cost, the BOCs'
5 opportunity and ability to engage in anticompetitive conduct would be severely constrained.
6 However, none of these conditions apply in the real world. As such, the use of a fair market
7 value imputation standard – codified at sections 272(b)(5), 272(c), and 272(e)(3) and as reflected
8 in the Commission's affiliate transaction rules (47 CFR §32.27) – were all aimed at assuring that
9 the BOCs derived no competitive advantages as a consequence of their partially integrated
10 provisioning of monopoly local and competitive long distance services that were not also
11 available to competing nonaffiliated carriers.
12
13 4. However, once the BOCs fully integrate their local and long distance services, Secs.
14 272(b)(5) and 272(c) will no longer apply. As a result, the costs associated with providing (the
15 now integrated) interLATA services will become more difficult to isolate and to quantify, and
16 thus become more prone to abuse. Moreover, if BOC-provided interLATA services are
17 classified as *non-dominant* such that the BOCs will not be required to file tariffs once the
18 separate interLATA affiliates are eliminated, there will be no proactive mechanism, other than
19 through an after-the-fact audit, to assure that the prices being charged for (the integrated)
20 interLATA services adequately compensate the BOC for the costs it incurs in producing them.
21 Although the Commission has decided to allow the Section 272 separate affiliate requirement to

sunset even though the BOC retains market power in the local market,[1] nothing in that decision entails surrendering the Commission's authority to implement and to enforce stringent safe-guards pertaining to the assignment of direct costs, the allocation of joint costs, and the sharing of common overhead costs, as between local and long distance services.

5. If a BOC's access charges to competing IXCs are significantly greater than the economic cost of comparable access functions that the BOC realizes *itself*, the BOC would have the ability to impose a price squeeze upon its nonaffiliated rivals by setting its retail end user prices at levels sufficient only to recover its own economic costs, while forcing competing providers to incur considerably higher out-of-pocket access charges. Imputation of both tariff access charges that an IXC would pay, and imputation of the costs that an IXC would incur to acquire (on a stand-alone, i.e., non-integrated basis) any non-tariff services being provided by the BOC for the benefit of its (affiliated or integrated) long distance business, can mitigate the potential for such price squeezes *but only to the extent that the imputation requirement is properly specified and effectively enforced.*

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1. *AT&T Petition for Extension Of Section 272 Obligations Of Southwestern Bell Telephone Co. In The States Of Kansas and Oklahoma*, WC Docket No. 02-112, at 7-8 (Dec. 8, 2003) (SWBT market share in Oklahoma was 89% and in Kansas 83% at the end of 2002, and SBC told investors that in the second and third quarters of 2003 it had significantly *reversed* its access line losses); *AT&T Petition for Extension Of Section 272 Obligations Of Verizon In The State Of Massachusetts*, WC Docket No. 02-112, at 7-8 (Feb. 19, 2004) (Verizon market share in Massachusetts was 81% as of the end of June, 2003 and Verizon, in its January 29, 2004 investor briefing, reported that in the most recent two quarters it has *reversed* the rate of UNE-P net additions).

1 6. The BOCs contend that integrated operation enables them to produce local and long
2 distance services at a lower combined cost than would prevail under Sec. 272 structural
3 separation.[2] The imposition of strict imputation and cost allocation requirements would not
4 require that any of these economies of scope be sacrificed, but would help to assure that those
5 gains from integration are properly allocated and inure to both segments of their (integrated)
6 operations in a manner that does not afford an undue or unique competitive advantage to the
7 (competitive) long distance business. The entirety of all potential efficiencies would be realized,
8 but such gains would be apportioned in a fair and competitively neutral manner. Conversely,
9 conferring such integration benefits to the long distance business in a disproportionately and/or
10 discriminatory manner would constitute a cross-subsidization of long distance by local.
11
12 7. The best – and economically efficient – means for addressing this problem would be to
13 require that access charges and the prices of any non-tariffed services being provided to the
14 BOC's long distance business unit (whether separated or integrated) be made available to non-
15 affiliated carriers at prices set at forward-looking economic cost. IXCs would then confront the
16 same costs for any tariff or non-tariff services they purchased from a BOC as the BOC itself
17 would confront. If the BOC elected to, in effect, "piggy-back" its long distance services onto its
18 core local services by imposing upon the former only the additional costs (over and above the
19 core services baseline), it would be required to offer those same "piggy-back" prices to non-

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2. See, *e.g.*, *Section 272(b)(1)'s "Operate Independently" Requirements for Section 272 Affiliates*, WC Docket 03-228, Comments of the Verizon Telephone and Long Distance Companies; Comments of SBC, Comments of BellSouth, filed December 10, 2003.

1 affiliated carriers. If access rates and any non-tariff LEC services used to provide BOC long
2 distance services were made available to non-affiliated carriers at prices set at forward looking
3 economic cost, cross-subsidization would be present only where the actual or effective intra-
4 corporate transfer price did not cover forward looking economic cost – or where no transfer price
5 was even being charged at all. This is sometimes referred to as the "ratepayer indifference"
6 standard – i.e., as long as the customers of core monopoly services are made no worse off by the
7 existence of the transfer, no cross-subsidization is present.
8
9 8. Where, as in the present circumstance, prices being charged to nonaffiliated carriers for
10 access and for non-tariff services such as billing and collection are set well in excess of forward
11 looking economic cost– and where some BOC functionality, such as joint marketing, is not even
12 available to nonaffiliated firms – a more comprehensive definition of "cross-subsidization"
13 becomes necessary. Generally, "cross-subsidization" occurs when telecommunications services
14 that are not subject to regulation by the Commission are priced below cost *either* (a) by using
15 revenues or profits being derived from services that are subject to the Commission's jurisdiction
16 or that of another regulatory agency, or (b) by affording the deregulated or nonregulated services
17 access to assets, resources, facilities and functions of the integrated, regulated firm without
18 bearing a fair share of their costs, or when a provider's deregulated services derive benefits from
19 the regulated operations without the regulated operations receiving just and reasonable compen-
20 sation from the deregulated operations for the benefits derived. The Commission should adopt
21 this definition of cross-subsidization and should implement a cost allocation and imputation

standard that ensures that long distance prices reflect the fair value of the functionality provided from the BOC.[3]

Section 272 (e)(3) already sets the proper imputation standard for access.

9. Where the BOC operates its in-region long distance business out of a separate affiliate, the 1996 Act imposes two specific sets of requirements aimed precisely at achieving the outcome described above – imputation of the full value of services undertaken on behalf of long distance operations. Although the RBOC Sec. 272(a) long distance subsidiaries were envisioned as being structurally separated from the BOC ILEC entities, they have nevertheless been permitted to make extensive use of their affiliated BOCs' tariffed and non-tariffed services.[4] Section 272(e)(3) requires that the full access charges be imputed into and used to establish a price floor for the BOC's long distance services. For other (non-access) tariff services, as well as for many (but not all) non-tariff services, Sec. 272(c) requires the BOC to make these

3. The full value of services undertaken by a BOC on behalf of its long distance operations should correspondingly be imputed as a revenue to be credited against the cost of providing the BOC's regulated monopoly local exchange and access services.

4. See, e.g. affiliate agreements posted at:
http://www.verizonld.com/regnotices/index.cfm?OrgID=1;
http://bellsouthcorp.com/policy/transactions/?PROACTIVE_ID=cecececececc6cecacfc5cecfcfcfc5cececbc9c7c9cbc6c6c6c5cf;
http://www.qwest.com/about/policy/docs/QwestLD/overview.html; http://www.sbc.com/gen/public-affairs?pid=3078

available to non-affiliated firms on the same basis as they are offered to its affiliate, and Section 272(b)(5) requires that the transfer price for such services be set at arm's length.

10. *Imputation of access charges and other tariffed services*. Sec. 272(e)(3), which remains in full force and effect even after the separate affiliate requirement has been sunset, requires that "a Bell operating company ... shall charge the affiliate described in subsection (a), or impute to itself (if using the access for its provision of its own services), an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service." Access charges applicable to interexchange carriers remain set well in excess of cost – perhaps by a factor of at least ten times. By requiring that the *price*, not the *cost*, of access be imputed into the BOC's cost of providing retail long distance service, the Act places a BOC in the same position as a nonaffiliated IXC with respect to the cost of obtaining access to the BOC's local customers.

11. The separated Sec. 272 affiliate is required to purchase and to utilize access and other "telephone exchange services" in exactly the same way as any nonaffiliated IXC – i.e., to purchase or provide dedicated transport to its Point of Presence ("POP") where the access connection is accomplished at a BOC end office, or to pay for common transport and tandem switching where the access connection occurs at a BOC access tandem. The affiliate is also required to pay for end office switching and for other miscellaneous access service rate elements,

as required. The affiliate must also purchase and pay for any other BOC telecommunications services at full tariff rates. However, once integrated with the BOC, the BOC's interLATA long distance services may be reconfigured so as to "ride" the BOC's network along with other BOC local and intraLATA traffic *rather than to utilize discrete access and other telephone exchange services per se*. Even where such reconfigurations produce efficiency gains, gains directly attributable to integrated operations, *the BOC is still required by Sec. 272(e)(3) to impute into its interLATA services the same access charges that it would have paid as a separate affiliate and that its nonaffiliated competitors will continue to pay*, irrespective of the actual network facilities arrangements that are being utilized. The elimination of the separate affiliate requirement may enable the integrated local/long distance carrier to reconfigure its network and routing so as to produce local and long distance services at a lower *combined* cost than would have been possible under structural separation. In that event, Sec. 272(e)(3) operates to ensure that *all of these gains from integrated operations inure to the benefit of the BOC's local services*. In addition to furnishing access services to the separate Sec. 272 affiliate, the BOC also provides the affiliate with a variety of *non-access* services, including joint marketing, customer service, billing and collection, and various corporate overhead and management functions, such as human resources, payroll, legal, accounting, procurement, and overall corporate governance. In its order issued March 17, 2004, the Commission now also permits the BOC to provide the affiliate with a

variety of operations, installation and maintenance ("OI&M") functions as well.[5] The ability of the affiliate to obtain access to BOC facilities and services enables the parent RBOC to realize some, albeit less than all, of the potential gains from full integration.

12. Transactions between the BOC and its Section 272 affiliate with respect to non-access tariff services and other non-tariff functions, resources and services are governed by Sec. 272(b)(5), Sec. 272(c), and by the Commission's affiliate transaction rules, 47 C.F.R. §32.27. These statutes and regulations operate to create a parallel transfer pricing and imputation arrangement with respect to *non-access* transfers as applies in the case of access. Section 272(b) requires that *all* transactions between the BOC and the Sec. 272 affiliate shall be conducted "on an arm's length basis with any such transactions reduced to writing and available for public inspection." Sec. 272(c) requires that "In its dealings with its affiliate described in subsection (a), a Bell operating company (1) may not discriminate between that company or affiliate and any other entity in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards; and (2) shall account for all transactions with an affiliate described in subsection (a) in accordance with accounting principles designated or approved by the Commission." Those "accounting principles" are set out at 47 C.F.R. §32.27 and require, generally, that where the ILEC provides assets or services to an unregulated affiliate, the transfer

5. *Section 272(b)(1)'s "Operate Independently" Requirements for Section 272 Affiliates*, WC Docket 03-228, *Report and Order*, FCC 04-54, March 17, 2004.

price be set at the greater of fully distributed cost or fair market value, and that where an unregulated affiliate furnishes services to the ILEC, such transfers be made at the *lesser* of fully distributed cost or fair market value. The *effect* of these requirements is to accomplish with respect to *non-access* transfers the same *economic* result as is accomplished through the "imputation of full access rate" requirement – *viz.*, to facilitate realization of integration efficiencies while assuring that the gains from such integration inure to benefit of the LEC's regulated services.

13. Prior to the sunset of the Section 272(b)(5) "arm's length" requirement, all costs of RBOC provision of interLATA services were booked as expenses reflected on the interLATA affiliate's books, facilitating the determination of a price floor for interLATA services and further assuring that the BOC was being compensated for services being furnished by it to the Sec. 272 affiliate. Thus, in addition to making costs transparent, Section 272(b)(5) served to ensure that the benefits of economies of scope that are available to a BOC providing support functions to its affiliate would remain with the BOC and inure to the benefit of the BOC's monopoly services. Since most of the relevant economies of scope stem directly from a BOC's legacy local service monopoly, allowing a BOC to pass those savings on to its affiliate competing in an adjacent, and fully competitive, market would provide the affiliate with an unfair cost advantage, one that was not available to any nonaffiliated IXC, and operate to divert

revenues that are being generated through the use (by the affiliate) of the BOC's assets and other resources over to the affiliate.

14. Although the Section 272(e)(3) access charge imputation requirement remains in full force and effect even after the sunset of the Section 272(a) separate affiliate requirement, the Section 272(b) transaction rules and the Section 272(c) nondiscrimination requirement are included within the provisions that are subject to the sunset. Without an equivalent replacement regulation, which the Commission has full authority to require under sections 201-205, 215, 218 and 220, the potential for a price squeeze and similar anticompetitive conduct on the part of the (now integrated) BOC becomes even greater than before, because a key set of safeguards will have been eliminated.

The same imputation standard is required for non-access services and functions under local/long distance integration.

15. In order to ensure that LEC long distance pricing reflects just and reasonable costs for joint functions provided in conjunction with local services, ILECs should be required to impute into long distance prices charges for all joint functions and the joint use of ILEC assets or resources that would satisfy the requirements of Sec. 272(e)(3) with respect to access and, for non-access services and functions, would satisfy the Commission's affiliate transaction rules as codified at 47 C.F.R. §32.27. Although the ILEC's local and long distance operations will be

integrated, the use of affiliate transaction rules as a basis for cost assignment will help to ensure that the gains from integrated provision of access and non-access services and functions are treated on an entirely equivalent and parallel basis, and are not used by the ILEC to afford itself an undue competitive advantage or to discriminate against and thereby to disadvantage the ILEC's long distance rivals.

16. Non-access functions and services fall into two distinct categories, each of which requires separate treatment for imputation purposes:

(1) Functions for which the gain from integration is directly attributable to the BOC's status as the legacy local service monopoly. Such functions include access to the BOC's legacy local service customer base (joint marketing of local and long distance services, OI&M, and billing and collection). Access services also fall into this category, and the Sec. 272(e)(3) imputation requirement recognized and accommodates this fact.

(2) Functions and services of a general nature, where the integration efficiency is more one of scale than of scope, arising from the size of the BOC rather than from its incumbency in the local telephone service market. Such functions would include human resources, payroll, legal, accounting, procurement and purchasing, real estate, and overall corporate governance.

17. Integration gains in category (1) are uniquely available to the incumbent LEC, whereas integration gains in category (2) would be available to any multi-product firm of comparable size. Different imputation requirements for each category are appropriate.

(1) For functions for which the gain from integration is directly attributable to the BOC's status as the legacy local service monopoly, BOCs should be required to identify the portion of a given activity or resource that jointly benefits its provision of local and long distance service. For the purposes of pricing long distance services, the BOC would be required to apply the following procedures for imputing charges to its long distance operations:

(a) Where 47 C.F.R. §32.27(d) would permit the use of prevailing company price (PCP) for services that meet the Commission's PCP requirements (i.e., where at least 25% of such services are being furnished to nonaffiliated entities), the prevailing company price(s) being charged to nonaffiliated entities would be imputed. (Note that with the sunset of the Section 272(c) nondiscrimination rules, the 0% threshold for services provided to Section 272 affiliates is no longer appropriate.) An example of such PCP-qualifying joint costs would be billing and collection services.

(b) Where a service or activity does not qualify for PCP, the greater of fair market value/estimated fair market value or fully distributed cost would be imputed into

the price floor for long distance services. As noted in the *Accounting Safeguards Order*, fair market value, should be determined by "requiring carriers to use methods that are routinely used by the general business community."[6] These methods can include best use, appraisals, catalogs listing similar items, competitive bids, replacement cost of an asset, and net realizable value of an asset.

(2) For functions and services where the integration efficiency arises from scale rather than from scope, costs should be allocated between local and long distance services on the basis of fully-distributed costs. In this manner, gains from integration are ratably shared across all of the BOC products and services that are being supported by these various overhead functions.

The distinction between these two types of activities corresponds with the distinction between "joint" vs. "common" costs that is widely recognized by economists and accountants.

18. Integration gains associated with joint production of monopoly and competitive services should inure to the monopoly service, because such gains are uniquely available solely to the monopoly service provider. By contrast, integration gains associated with common overhead

6. *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Report and Order*, FCC 96-490, 11 FCC Rcd 17539, 17610 (1996), at para. 154.

functions are available to any firm of comparable size, and should thus be spread equitably across all of the products and services that such common overhead functions support.

Satisfaction of the imputation requirement, and establishment of price floors, must be done on a service-by-service basis so as to minimize the potential for cross-subsidization and other anticompetitive pricing conduct.

19. As part of their "joint marketing" of local and long distance services, the BOCs and their Sec. 272(a) long distance affiliates have been introducing service "bundles" that include regulated basic local exchange access, local and intraLATA toll calling, discretionary (and sometimes flexibly priced under state PUC tariffs) vertical features, and nonregulated services such as long distance, voice mail, and wireless services furnished by one or more BOC affiliates. Because the individual components of these "bundles" confront widely varying competitive conditions, it is essential that an imputation test with respect to each *competitive service* component of the bundle be applied separately for each such component. The potential for similar cross-subsidization also exists with respect to services furnished on an *a la carte* basis if the RBOC is allowed to satisfy imputation on an aggregate, rather than service-by-service.

20. Bundling of local and long distance services enables the BOC to exploit its market power with respect to local dial tone into the adjacent long distance market. And although local exchange access rates are, for the most part, still subject to regulation, BOCs have been afforded considerable pricing flexibility and, in some cases, outright de-tariffing, of a number of

discretionary service elements that are built on the basic local dial tone platform. These service elements fall into two principal categories:

(1) *Services and features that can be provided by the BOC only to customers who also take basic dial tone service from the BOC.* Examples of such services include local (non-toll) calling, switched access to/from long distance carrier services, certain vertical and CLASS features, such as call waiting, caller ID, voice mail with call waiting and/or caller ID, selective ringing, call forwarding (all varieties), and *69 call return.

(2) *Services and features that utilize the dial tone line platform and that can be provided by the BOC, but which are also available from other sources, albeit sometimes in a more cumbersome manner.* Examples include speed dialing, 3-way calling, voice mail (without call waiting or caller ID), and conference calling, in addition to intraLATA and interLATA calling.

Because services in category (1) cannot be obtained from a carrier other than the one that provides the customer's basic local dial tone access line, they provide the BOC with greater profit opportunity than for services in category (2). Since the BOCs continue to control the overwhelming share of the local dial tone market, their pricing discretion with respect to any services in this category that are not subject to price regulation is constrained principally by demand elasticities. Services in category (2) confront competition from alternative sources, limiting the BOCs' pricing opportunities to competitive market conditions.

21. If the BOCs were permitted to use profits obtained from services in category (1) to cross-subsidize the competitive services in category (2), the result would be to undermine competition in these otherwise competitive services. If a service bundle combining category (1) and category (2) services were required only to satisfy an imputation test *in the aggregate* – i.e., across all of the components of the bundle combined – there would be no means for detecting, let alone preventing, precisely this type of cross-subsidization.

22. It is for this reason that the price floor including imputation needs to be satisfied individually for each of a BOC's various long distance services and pricing options so as to preclude the possibility of revenues/profits from any noncompetitive *a la carte* services, or from one or more noncompetitive components of a service bundle, being used to cross-subsidize *a la carte* or bundled long distance services. Additionally, any bundle consisting of basic local exchange (dial tone) service, local calling, vertical features, intraLATA and interLATA toll, and any other components or features must be priced, in the aggregate, at a level sufficient to recover the aggregate of all tariff prices of all tariff services (or their functional equivalents) included within the bundle (e.g., local dial tone, local calling, vertical features) together with all other imputed and directly-assigned costs applicable to the bundled offering. A service-by-service imputation requirement puts the BOC in essentially the same economic condition as its non-affiliated rivals. The BOC should be required to demonstrate, for each identifiable long distance service offering or long distance component of a service bundle, as well as for the bundle as a whole, that the revenues being derived therefrom exceed the sum of the access charges and

other tariff rates that it would have had to pay were it a separate, nonaffiliated entity *plus* the imputed and actual non-tariff costs it incurs in providing the service or bundle at retail.

23. Where a service offering consists of a bundle of multiple services (such as local dial tone, vertical features, and long distance) under a single, unified pricing plan, the effective additional charge for the long distance component in the bundle (i.e., the difference between the price of the bundle with long distance and the price of the bundle without it) should similarly exceed the sum of imputed access charge (or other underling services being furnished by the BOC) plus the additional non-access costs. For example, Verizon New England offers customers in Eastern Massachusetts a bundle of local service, vertical features and intraLATA toll at a monthly rate of $39.95, but also offers an otherwise comparable bundle, but without any toll, for $37.95. Hence, Verizon New England's retail price for *unlimited intraLATA toll* is only $2 a month. Similarly, Verizon New York offers a New York Metro LATA bundle including unlimited local and intraLATA calling, plus an array of vertical features, for $44.95, but also offers the same bundle but without intraLATA calling for $42.95, also implying a $2 per month price for unlimited intraLATA usage. It is this $2 price for unlimited intraLATA toll calling, and not the full price of the bundle, that should be required to satisfy the imputation requirement, i.e., to exceed an imputed price floor based upon the average volume of intraLATA calling that customers of this service present.

24. Individual services differ both with respect to costs and revenues. Carriers will typically incur higher customer acquisition costs with respect to high-value services, such as flat-

rated bundles of local, long distance, Internet access, and perhaps even wireless, than they would to acquire, for example, a by-the-call long distance customer. Other costs, such as the fixed components of billing and collection and customer service functions, may be somewhat lower for customers with high calling volumes or who take multiple services in a package or bundle. On the revenue side, competition will work to narrow the potential operating margin. While there is a general requirement that the price of a bundle of services be profitable relative to the cost of the entire bundle, there is a special imputation requirement where a portion of the bundle consists of monopoly BOC local services and service features that are integrally linked to the basic dial tone platform. In such an event, a BOC must not be permitted to use revenues from the highly profitable vertical features that are included in a service bundle to cross-subsidize the long distance components of that bundle. For such purposes, the "price" of the long distance component may be determined as the difference between the price of the entire bundle including long distance and the price of an equivalent bundle or collection of services *except for long distance*.

25. Carriers frequently offer *promotional pricing* as an inducement to attract new customers. Such promotions may consist of free or discounted service for a limited number of months and/or an up-front cash (or other in-kind) payment to the customer for signing up for the service. The service-specific imputation requirement should apply to such offerings, to be satisfied over the average service retention period (up to twelve months) or contractual term, whichever is greater. For example, if a BOC offers a competitive long distance service for $25 with the first month free and no installation charges, and the average retention period for the

service is twelve months, the effective monthly price for the service would be computed as (11x$25)/12 = $22.92, which would need to exceed the imputed charges, *including installation costs*, applicable to the service.

26. If the promotional offer is linked to a bundle that includes any category (2) components, for imputation and price floor purposes the promotional discount must be applied solely with respect to the additional charge for the category (2) component(s). For example, supposing that a BOC offers a bundle consisting of local dial tone, unlimited local calling, and a collection of vertical features for $40 but without any promotion or discount, and also offers a similar bundle but including unlimited intraLATA and interLATA calling for $55 per month with the first month free. The differential price of the intraLATA/interLATA calling feature is $15 per month (i.e., $180/year), but the $55 value of the "free" month must be applied solely with respect to this intraLATA/interLATA component, bringing its effective price to $125 per year, or $10.42 per month. It is this $10.42 that must satisfy the imputation test with respect to access charges and any non-tariff services that are associated with the long distance component of the bundle.

The existing processes for allocating costs between an ILEC's regulated and nonregulated operations, as set forth at 47 CFR §64.901 are not sufficient to properly address the vast amount of joint costs present in the integrated provision of regulated local and nonregulated long distance services.

27. Under the Commission's current Part 64 allocation rules, revenue, expense and investment accounts are analyzed for the purpose of separating these items as between regulated

and nonregulated services. However, once placed in the "nonregulated" column, no further disaggregation, e.g., on a service-by-service basis, is required. As explained in my July 28, 2003 Reply Declaration appended to AT&T's Reply Comments in this proceeding, competitive services such as long distance should continue to be treated as non-regulated under Part 64 such that these costs and associated revenues may be isolated from those applicable to regulated monopoly services.[7] However, the Part 64 allocations do not identify revenues and costs associated with long distance services for the purposes of imputation. Since the costs and revenues for nonregulated services are typically aggregated for the purposes of Part 64, revenues and expenses associated with long distance products are mixed in with many other nonregulated services provided by the carrier, such as inside wire maintenance and DSL. This aggregation of products serves to conceal the costs and revenues specifically associated with long distance products, and makes any long distance imputation test that might be based upon Part 64 allocations impossible. Part 64 should be modified to require that nonregulated costs and revenues be allocated according to the modifications I have recommend here, and be maintained on a disaggregate basis, by product line.

28. Part 64 and the various RBOC cost allocation manuals that purport to implement them generally separate expenses and investments as between regulated and nonregulated services on the basis of fully-distributed costs, with the specific allocations typically driven *not* by cost-causation factors, but instead by arbitrary allocators based upon, for example, relative usage or

7. Selwyn (AT&T) Reply, filed July 28, 2003, at para. 57.

other simple metrics. An RBOC's motivation for a particular plant acquisition or upgrade may be for the purpose of furnishing a nonregulated service, but once acquired or upgraded the plant may be used jointly to furnish regulated and nonregulated services. In such an event, the costs associated with such newly acquired or upgraded plant would then be apportioned between these two categories in some manner than would bear no economically rational relationship with the cost drivers themselves.

29. For example, a BOC might replace perfectly serviceable copper loop plant with fiber for the sole and express purpose of providing nonregulated broadband services. If, once in place, the new fiber optic facility is also used to provide plain old telephone service (POTS), then a potentially large portion of its cost would, under Part 64, be allocated to POTS and away from the nonregulated broadband service. If the nonregulated broadband services are then co-mingled with nonregulated long distance services, the "profits" available from broadband (due to the underallocation of costs to broadband) could then be used to cross-subsidize long distance. Part 64 is not, as presently constituted, an effective tool either for detecting or for preventing such cross-subsidization.

30. Part 64 should be modified so as to specifically address this concern. Absent a showing to the contrary, all BOC investments in plant, facilities or equipment that will be jointly used for the benefit of regulated and nonregulated services within five years of the date of acquisition and installation of that plant should be presumed to have been acquired primarily for the benefit of the nonregulated services. Based upon this (rebuttable) presumption, any increase in net invest-

ment for the replacement assets in excess of the remaining net book cost of the plant being replaced should be allocated to and imputed into the price floor applicable to the nonregulated service.

Enforcement of any imputation standard – including the imputation of access charges and other tariff services as required by Sec. 272(e)(3) – requires dominant carrier treatment of integrated BOC long distance services.

31. As a practical matter, the statutory requirement for access charge imputation at Sec. 272(e)(3) could neither be monitored nor enforced – except perhaps long after-the-fact – if BOC long distance services are afforded non-dominant status. Non-dominant treatment by the FCC of BOC long distance services would work to exempt the BOCs from filing interstate tariffs for their long distance, private line, and other services, without which there would be no mechanism for the Commission to review, let alone enforce, the statutory imputation requirement. After-the-fact enforcement would necessarily involve protracted delays, during which time the BOC would be able to violate the statutory requirement (along with any other regulatory imputation requirements that the Commission may impose, such as those discussed above) and in so doing impose an unlawful price squeeze upon nonaffiliated IXCs.

32. Rapidly increasing RBOC in-region long distance market shares are *in and of themselves* fully sufficient to justify subjecting the BOCs to dominant carrier regulation, *even where the RBOCs continue to operate their long distance business through a separate affiliate.*

Figure 1 below is a reproduction of a chart that was provided by Verizon at its January 29, 2004 quarterly securities analyst briefing to present its fourth quarter 2003 results. In this chart, Verizon provides its retail long distance market shares of local consumer service customers, *state-by-state*. Only four years after gaining Section 271 in-region authority in New York, Verizon had amassed an impressive 61% share; after only three and a half years in Massachusetts, Verizon's share had reached 52%. Verizon is not alone in its ability to gain overwhelming market share through its ability to exploit its preexisting dominance of the local service market. As shown in Figure 2, SBC announced that it had achieved a nearly 60% market share in Texas only 39 months after entry, with similar trends in Kansas, Oklahoma, Missouri, Arkansas and California.[8] Using the data contained on these two charts, I constructed a linear regression analysis for the former Bell Atlantic and NYNEX Verizon states (those that were subject to Section 271) and the six SBC states included in Figure 3, with the RBOCs' retail share in each state as the dependent variable and the months since long distance entry as the principal explanatory variable (see Figure 3 below). Attachment 1 provides the regression results and the source data used. The model revealed a highly significant relationship between the months since entry and market share, with a *t*-statistic of 19.65, indicating statistical significance in excess of 99.9%. The explanatory power of the model was also quite high, as indicated by an R^2 of .93, i.e., that time since entry explains 93% of the variation in achieved market share. The model

8. SBC Analyst Conference 2003, at slide 10, available at: http://www.shareholder.com/sbc/downloads/AnalystPres_nov03.pdf.

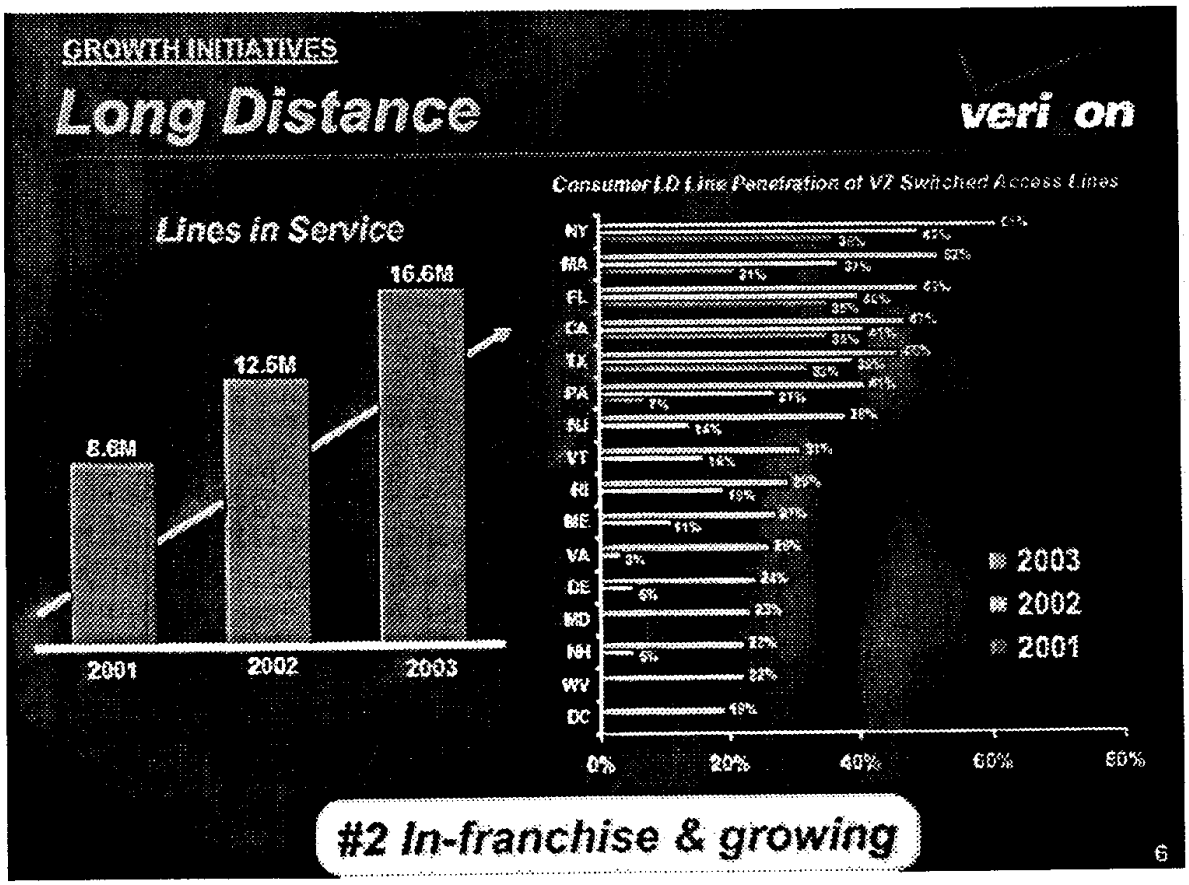

Figure 1. Verizon Long Distance Penetration.

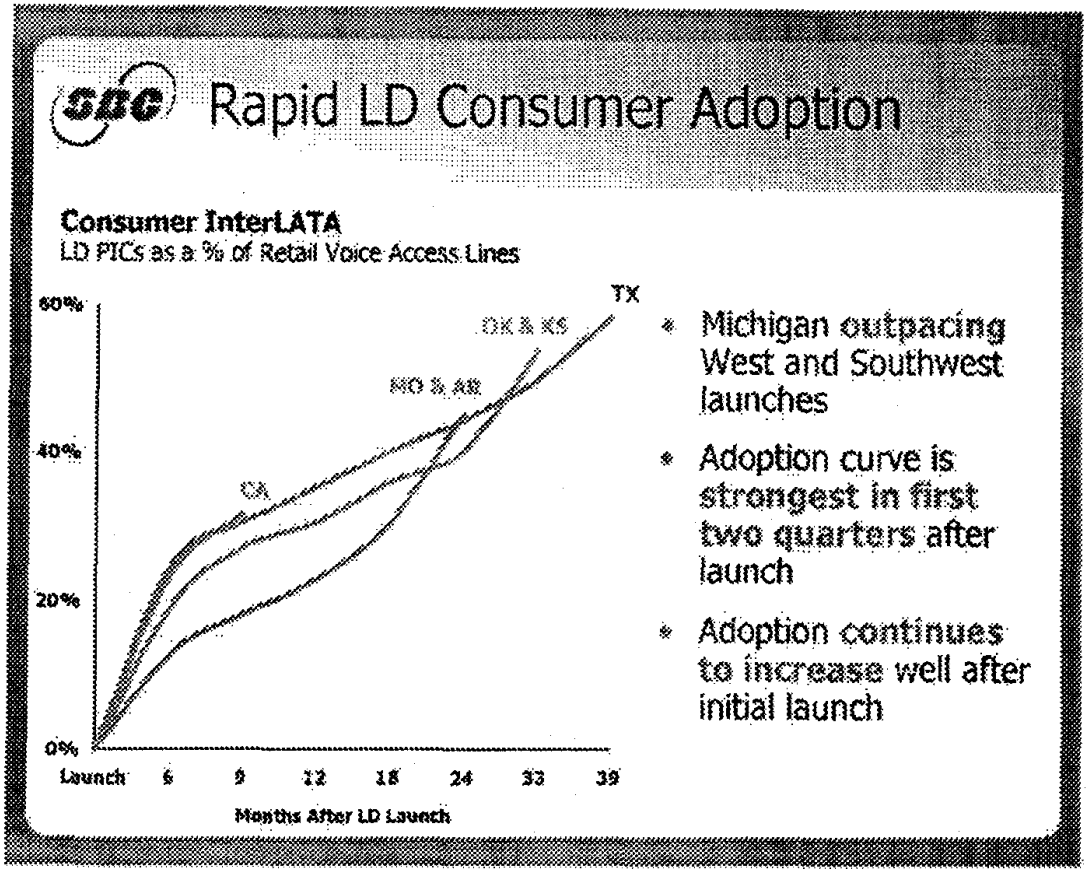

Figure 2. SBC Long Distance Shares

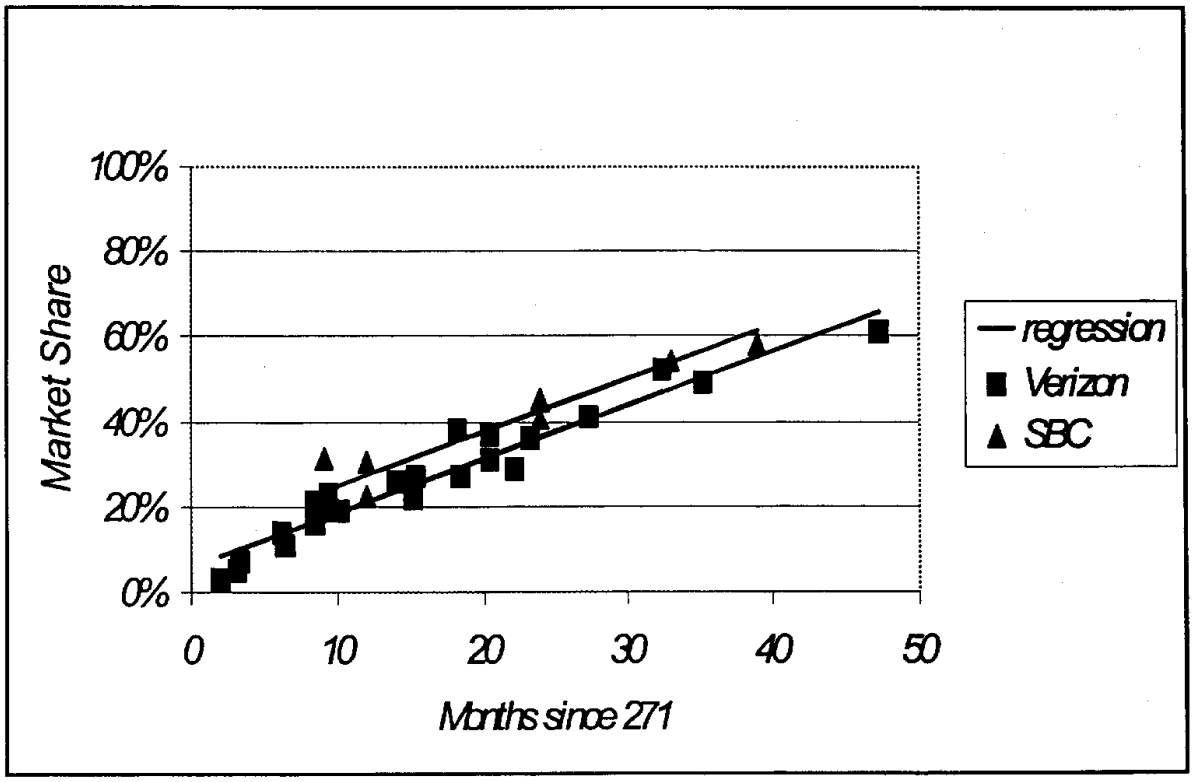

Figure 3. Regression output analysis of Verizon and SBC Long Distance market share (by stste) by length of time since 271 approval.

1 indicates that Verizon and SBC have been able consistently to acquire an additional 1.27%
2 market share per month since initial entry into a given jurisdiction. Even in the states with the
3 longest RBOC long distance presence, the rate of market share growth shows no sign of slowing.
4 Moreover, it appears that the RBOCs' rate of market share acquisition has actually improved as
5 they gained entry in successive states, suggesting that the companies are getting even better in
6 exploiting their legacy local service customer base as they gain additional experience in
7 marketing long distance service.[9] These real-world market outcomes also demonstrate that the
8 separate affiliate and affiliate transactions requirements of Section 272 have certainly not
9 impaired the RBOCs' competitive effectiveness in capturing retail long distance market share.

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9. I would note that in a Declaration I submitted on May 3, 2002 on behalf of AT&T in the Virginia State Corporation Commission's Section 271 consultative proceeding, Case No. PUC-2002-0046, I presented the results of a simulation model that I had developed for the purpose of predicting the growth in Verizon's long distance market share stemming, specifically, from its ability to exploit the "inbound channel" – incoming calls placed by customers to Verizon for the purpose of ordering new *local* telephone service. My model had predicted that after four full years of long distance entry, Verizon would have captured a 55.8% share. As it turns out, my prediction was conservative, since Verizon has achieved a 61% share after four years in New York. In a declaration I submitted to the California Public Utilities Commission on behalf of Pac-West Telecomm and Working Assets Long Distance, I provided the California results of the same model. Again, my model under-predicted California results, projecting less than 20% long distance market share in the first year, whereas SBC has announced a 31% market share after nine months. *Rulemaking on the Commission's Own Motion to Govern Open Access to Bottleneck Services and Establish a Framework for Network Architecture Development of Dominant Carrier Networks*, R.93-04-003, *Investigation on the Commission's Own Motion into Open Access and Network Architecture Development of Dominant Carrier Networks,* I.93-04-002, *Order Instituting Rulemaking on the Commission's Own Motion Into Competition for Local Exchange Service*, R.95-04-043, *Order Instituting Investigation on the Commission's Own Motion Into Competition for Local Exchange Service,* I.95-04-044, Declaration of Lee L. Selwyn, August 23, 2001.

33. Appendix 1 to this Declaration provides sample text for an imputation rule that is intended to addressed the various issues I have discussed herein.

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

LEE L. SELWYN