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October 20, 2004

Ex Parte

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: <u>AT&T Petition for Rulemaking to Reform Regulation for Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, RM-10593</u>

Dear Ms. Dortch:

Please place the attached letter on the record in the above proceeding.

Sincerely,

Susanne A. Guyer

Attachment

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Senior Vice President
Federal Regulatory Affairs

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October 20, 2004

Honorable Michael K. Powell
Chairman
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: <u>AT&T Petition for Rulemaking to Reform Regulation for Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, RM 10593</u>

Dear Chairman Powell:

One of the success stories for the FCC in recent years has been its pro-competitive deregulation of special access prices. AT&T would now like the Commission to reverse that policy and turn back the clock to the days of now widely discredited rate of return regulation, but its arguments for doing so are misplaced.

The Commission's pricing flexibility rules provide bright line standards that define the circumstances under which special access services may be offered under contract, without being subject to extensive rate regulation. These standards require clear evidence that competitors have entered a given market with their own competitive fiber. The resulting pricing flexibility has allowed carriers like Verizon to compete more aggressively to offer high capacity services both on a wholesale basis to other carriers and to end user customers, including in the enterprise segment of the market that is dominated by AT&T and the other traditional long distance companies.

AT&T's pending petition to re-regulate these services nonetheless claims that special access prices have increased since the Commission adopted its pricing flexibility rules. As we have explained previously, that claim is false. Information recently submitted to the Commission in a parallel proceeding provides further confirmation that the prices customers actually pay for special access have declined substantially under the pricing flexibility rules.

Contrary to AT&T's claims, the facts show not only that special access prices are *declining*, but also that "special access pricing flexibility, together with increasing competition in the market, has led to a *faster* decline in average revenue per special access line during the pricing flexibility period than before." Taylor Decl. ¶ 11 (emphasis added).[1] Indeed, AT&T focuses on tariffed month to month rates that few customers use, and ignores the prices that customers actually pay. And an analysis of what customers actually pay demonstrates that Verizon's special access prices, adjusted for inflation, fell ***13.8%*** annually from 1996-2000, before pricing flexibility, and by an even greater ***22.2%*** annually from 2001-2003, once pricing flexibility became available. *See* Taylor Reply Decl. ¶ 8. AT&T claims that these reductions are solely a function of that fact that customers have shifted to using higher capacity special access services, such as DS-3s or above, that have a lower effective price. Again, that is not true. The fact of the matter is that these reductions in the prices customers actually pay occurred not only for Verizon's overall special access prices, but also for specific services, including DS1 service. Verizon's DS1 channel termination prices, adjusted for inflation, fell at an *annual* rate of ***6.5%*** between January 2001 and April 2004. *See id.* ¶ 21.

AT&T also claims that the returns reflected in regulatory reports also somehow show that the prices for special access are too high. Dr. Taylor and Dr. Kahn explain that the methodology relied on by AT&T and others for calculating BOCs' net return on special access — the use of fully distributed, or allocated, costs — is "economic nonsense." *Id.* ¶ 14. This is so because the return figures they cite are based on arbitrary allocations of costs between regulatory jurisdictions and between various categories of services. Indeed, the same reports show that Verizon's returns on switched access services are only 7.81% percent. Under AT&T's theory, therefore, the prices for these services would have to be substantially increased to produce a reasonable return. The fact that these reports are economically meaningless is not only what Dr. Taylor and Dr. Kahn conclude, but also what AT&T's own economists agree is correct. Thus, Dr. Willig has explained that "[f]ully allocated cost figures and the corresponding rate of return numbers simply have *zero economic content*." *Id.* ¶ 14 (quoting W.J. Baumol, M.F. Koehn, and R.D. Willig, "How Arbitrary is 'Arbitrary'? – or, Toward the Deserved Demise of Full Cost Allocation," *Public Utilities Fortnightly*, Vol. 120, No. 5, Sept. 3, 1987, at 21) (emphasis added). And AT&T itself has shared the same view, when it was the carrier subject to regulation, explaining that "determining a cost basis for calculating an economically meaningful rate of return *is impossible*." *Id.* ¶ 15 (quoting Initial Brief of AT&T Communications of New England, Inc., DPU 91-97, at 42-43 (Mass. DPU filed Apr. 23, 1992)) (emphasis added).

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[1] *See* Declaration of William E. Taylor Regarding Special Access Pricing (Oct. 4, 2004) ("Taylor Decl.") (Attachment G to Comments of Verizon, WC Docket No. 04-313 & CC Docket No. 01-338, *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (FCC filed Oct. 4, 2004)); Reply Declaration of William E. Taylor (Oct. 19, 2004) ("Taylor Reply Decl.") (Attachment C to Reply Comments of Verizon, WC Docket No. 04-313 & CC Docket No. 01-338, *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (FCC filed Oct. 19, 2004)). For convenience, both of these declarations are attached to this letter. *See* Attachments 1 and 2.

In short, there simply is no justification for repeal of the pricing flexibility relief Verizon has obtained or a return to rate of return regulation AT&T requests.

Sincerely,

Susan Ginzer

Attachments

cc: Commissioner Kathleen Abernathy
Commissioner Jonathan Adelstein
Commissioner Michael Copps
Commissioner Kevin Martin
Scott Bergmann
Matt Brill
Dan Gonzalez
Christopher Libertelli
Jessica Rosenworcel
Jeff Carlisle
Steve Morris
Tamara Preiss
John Rogovin
Austin Schlick

ATTACHMENT 1

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Unbundled Access to Network Elements	)	WC Docket No. 04-313
	)	
Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers	)))	CC Docket No. 01-338

Declaration of William E. Taylor Regarding Special Access Pricing On Behalf of Verizon

October 4, 2004

DECLARATION OF WILLIAM E. TAYLOR
REGARDING SPECIAL ACCESS PRICING
ON BEHALF OF VERIZON

SUMMARY

1. I have been asked to update data presented to the Commission in December 2002 regarding RBOC and Verizon special access revenue per line in the periods before and after limited pricing flexibility was made available to RBOCs in certain areas. Using the most recent ARMIS data, special access prices as measured by special access revenue per line have decreased rapidly over the 1996-2003 period. In addition, special access prices have fallen substantially <u>more</u> rapidly in the recent years (2001-2003) that correspond to the period in which pricing flexibility has been available than in previous years (1996-2000).

2. These data are thus inconsistent with the claim that pricing flexibility has led to price increases for special access services. More importantly, the data support the FCC's view that competitive market forces are sufficient to constrain ILEC special access pricing behavior and have generally forced RBOC prices downward in the aggregate towards cost.

I. Introduction and Background

3. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc., head of its Communications Practice, and head of its Cambridge office located at One Main Street, Cambridge, Massachusetts 02142.

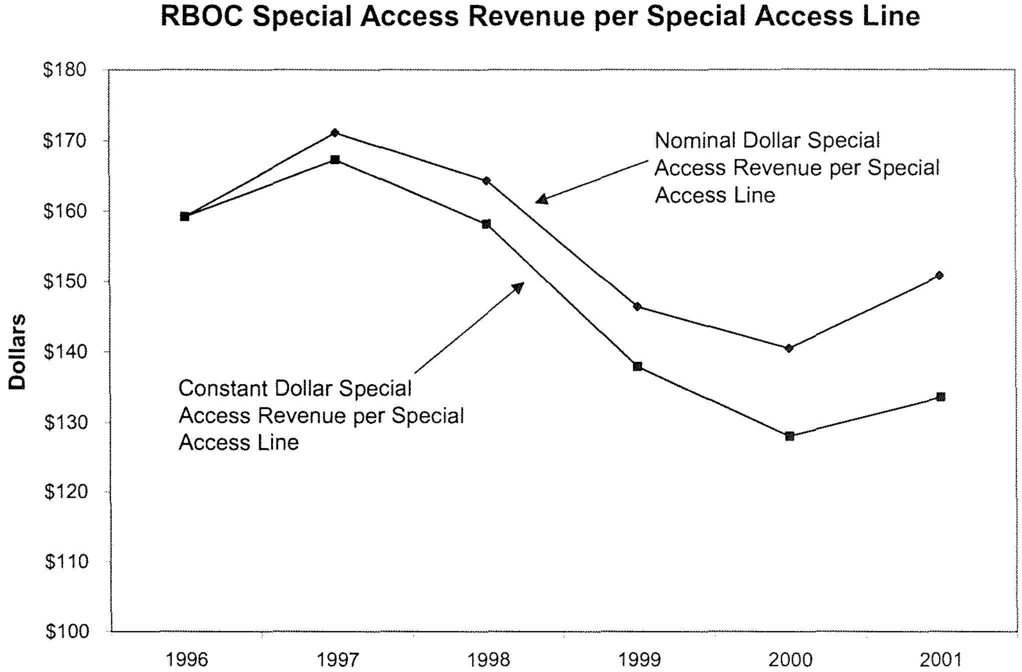
4. I have been an economist for over thirty years. I earned a Bachelor of Arts degree from Harvard College in 1968, a Master of Arts degree in Statistics from the University of California at Berkeley in 1970, and a Ph.D. from Berkeley in 1974, specializing in Industrial Organization and Econometrics. For the past twenty-five years, I have taught and published research in the areas of microeconomics, theoretical and applied

econometrics and telecommunications policy at academic and research institutions including the Economics Departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts Institute of Technology. I have also conducted research at Bell Laboratories and Bell Communications Research, Inc. I have appeared before state and federal legislatures, testified in state and federal courts, and participated in telecommunications regulatory proceedings before state public utility commissions, as well as the Canadian Radio-television Telecommunications Commission, the Mexican Federal Telecommunications Commission and the New Zealand Commerce Commission.

5. Almost two years ago, A.E. Kahn and I filed with the Commission a joint Declaration concerning an AT&T petition to retract pricing flexibility for RBOC special access services.[1] Among the data we provided was a chart (shown below) of RBOC special access "prices"—actually ARMIS Special Access Revenue per voice grade equivalent circuit—for the 1996-2001 period. From these data, we concluded that

> the *growth* in special access lines fully explains the growth in revenue and that the RBOCs' average revenue per line between 1996 and 2001 decreased by more than 1 percent per year in nominal terms and by more than 3 percent per year in constant dollars. [Footnote: Even these decreases are somewhat understated insofar as special access revenue includes DSL revenue but special access lines do not include DSL lines.]

[1] Declaration of Alfred E. Kahn and William E. Taylor on Behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and Verizon, In the Matter of AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, (RM No. 10593, December 2, 2002).



> Thus, the pricing flexibility exercised by some RBOCs during 2001 had no noticeable effect on their special access revenues per line, and AT&T's dire complaints of massive price increases likewise appear to be belied by the data.[2]

6. The issue of RBOC special access pricing during the period of pricing flexibility has arisen again,[3] and I have been asked by Verizon to update these estimates to give a picture of the effect of pricing flexibility and other market changes on the pricing of special access circuits. This update is particularly relevant because pricing flexibility had only just begun at the end of the data shown above,[4] and thus little information was available to Dr. Kahn and me regarding the effect of the FCC's grant of pricing flexibility on special access prices.

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[2] Kahn-Taylor Declaration at 15-16.
[3] *See*, Ad Hoc Telecommunications Users Committee, "Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Markets," August 2004.
[4] The first grants of pricing flexibility for special access services in some areas took place for BellSouth on December 15, 2000 and for Verizon and SBC on March 14, 2001.

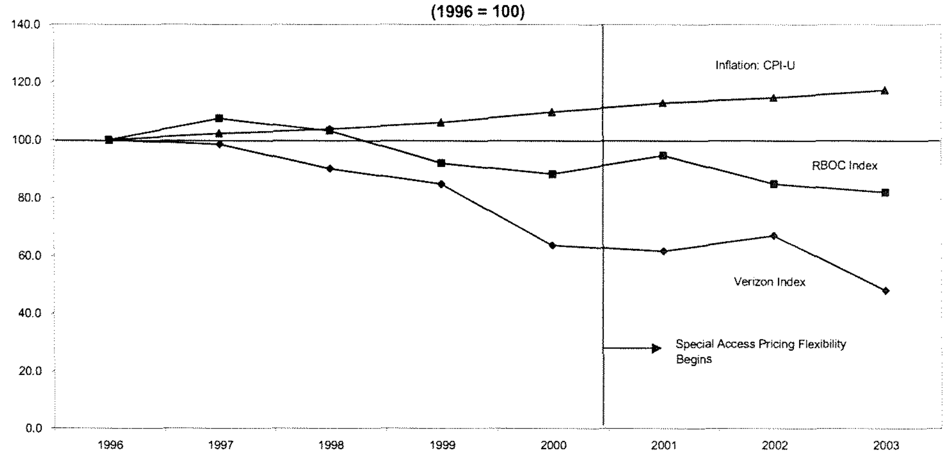
II. RBOC Special Access Pricing

7. Following the calculations and data sources in the Kahn-Taylor Declaration, I took data from the ARMIS Reports as of September 17, 2004. Volumes of analog and digital special access lines, measured in voice-grade equivalents were taken from ARMIS Report 43-08, row 910. Special Access revenue was taken from ARMIS Report 4303, row 5083. I calculated average revenue per special access line for Verizon and for the RBOCs as a whole both in nominal terms and in real terms, using the Bureau of Labor Statistics Urban CPI as the deflator.

8. Note, as Professor Kahn and I observed in 2002, that ARMIS special access revenue includes DSL revenues, but the ARMIS special access lines do not include DSL lines, which are the high-frequency components of ordinary switched access lines. Moreover, DSL revenues have been growing rapidly, both in absolute terms and relative to special access revenues. Thus, the average revenue per special access line I calculate here *overstates* both the level and growth of special access prices, as measured by average special access revenue per special access line.

9. Indexed to 1996=100, nominal special access prices for Verizon and the aggregate of the RBOCs are shown below for the 1996-2003 period in Figure 1 followed by the same information measured in real terms in Figure 2. In Figure 1, I include the Bureau of Labor Statistics' Consumer Price Index as a measure of inflation. The fact that the CPI-U increased during the period means that special access prices were falling during a period when consumer prices, on average, were rising.

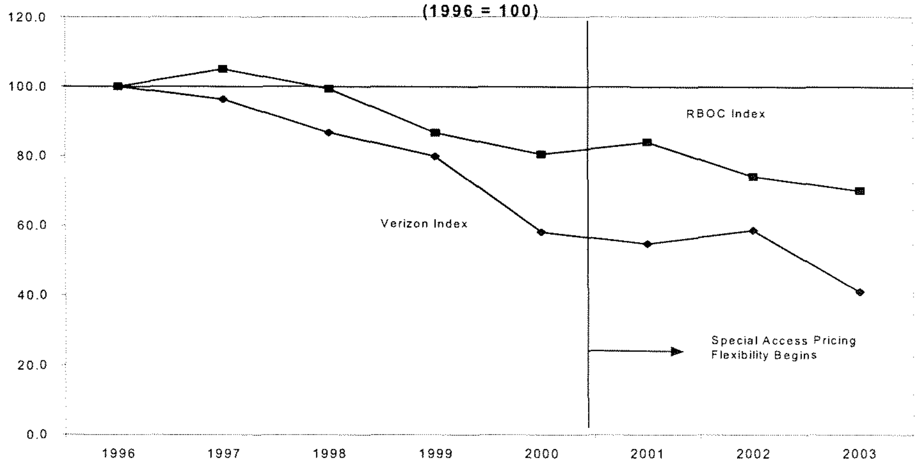
Figure 1
Nominal Special Access Revenue per
Special Access Voice Grade Equivalent
(1996 = 100)



Source: FCC ARMIS Report 43-08, 43-03, BLS

10. Figure 2 takes inflation into account, showing (real) average special access revenue per special access line measured relative to inflation in constant 1996 dollars.

Figure 2
Real Special Access Revenue per
Special Access Voice Grade Equivalent
(1996 = 100)



Source: FCC ARMIS Report 43-08, 43-03

11. These data show that the first conclusion from our December 2002 paper is still valid: special access revenue per line is decreasing steadily. However, our second conclusion changes with the acquisition of additional data after pricing flexibility. Rather than "no noticeable effect" (based on one year of data), the onset of special access pricing flexibility, together with increasing competition in the market, has led to a <u>faster</u> decline

in average revenue per special access line during the pricing flexibility period than before. Table 1 below compares annual growth rates for Verizon and the aggregate of the RBOCs for the 1996-2003 period, divided into the pre-pricing flexibility period (1996-2000) and post-pricing flexibility period (2001-2003).

Table 1
Special Access Revenue per Line

Period		Nominal Annual Growth	Real Annual Growth
All Data 1996 – 2003	RBOC	-2.8%	-5.0%
	Verizon	-9.9%	-12.0%
Before Pricing Flexibility 1996-2000	RBOC	-3.1%	-5.3%
	Verizon	-10.7%	-12.7%
During Pricing Flexibility 2001-2003	RBOC	-7.0%	-8.7%
	Verizon	-11.7%	-13.4%

III. Conclusions

12. Both RBOC and Verizon special access revenue per line have continued to decline in nominal and real terms and at a faster rate during the period in which limited pricing flexibility has been available to these companies in certain areas. These data are clearly inconsistent with the claims that pricing flexibility has led to price increases for special access services. On the contrary, they support the FCC's view that market forces in special access markets that meet its trigger conditions are sufficient to constrain RBOC pricing and drive special access prices towards cost.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on October 1, 2004

Dr. William Taylor
NERA

ATTACHMENT 2

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	
Unbundled Access to Network Elements	WC Docket No. 04-313
Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers	CC Docket No. 01-338

REPLY DECLARATION OF WILLIAM E. TAYLOR
ON BEHALF OF VERIZON

SUMMARY

1. In my initial declaration, I used ARMIS report data to demonstrate that average revenue per special access line has fallen, and that the drop has accelerated since the ILECs received special access pricing flexibility. In this reply declaration, I refine those calculations and respond to criticisms.

2. First, I remove DSL revenue from the calculation and show that average revenue per voice grade equivalent fell about 21 percent per year during the pricing flexibility period and about 12 percent per year while under price caps. Thus average revenue per voice grade equivalent fell faster after pricing flexibility was in place.

3. Second, I explain that using fully distributed costs and accounting earnings to assess prices flatly contradicts the admonitions of a generation of economists, including those associated with the Commission and with AT&T.

4. Third, I respond to AT&T 's claims that the observed price reduction in special access is due primarily to customer migrations to higher-capacity, lower-priced special access services, rather than to price reductions and customer migrations to discount

contracts. If AT&T were correct, the prices of individual services (such as DS1 or DS3) would not fall, but Verizon has shown that for a single service (DS1), price reductions and migrations to discounts and term and volume contracts did result in significant price reductions during the price flexibility period. As a result, the observed shift in demand towards high-capacity services cannot account for the reduction in average revenue per voice grade equivalent.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	
Unbundled Access to Network Elements	WC Docket No. 04-313
Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers	CC Docket No. 01-338

I. Introduction and Background

5. My name is William E. Taylor. I am Senior Vice President of National Economic Research Associates, Inc., head of its Communications Practice, and head of its Boston office located at 200 Clarendon Street, Boston, Massachusetts 02116. I filed a declaration in this Docket on October 4, 2004, which listed my credentials.[1]

6. I have been asked by Verizon to respond to economic allegations made by AT&T regarding my analysis of special access prices and services. In particular, AT&T claims that the fact that average special access revenue per voice grade equivalent ("VGE") fell does not imply that prices have fallen but "tell[s] a quite different story:" (i) that regulation and price caps contributed to the reduction, (ii) that cost reductions and earnings increases took place and (iii) that a shift in the mix of services towards high capacity services having a lower price per VGE explains the reduction in average revenue per VGE. None of these explanations is correct.

7. In this Reply Declaration, I address these three alleged shortcomings of my average revenue per VGE analysis. In addition, I use Verizon DSL revenue data for 2002 and 2003 to eliminate the problem—identified in my previous Declaration and in my 2002

[1] Declaration of William E. Taylor on Behalf of Verizon, *In the Matter of Unbundled Access to Network Elements and Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (WC Docket No. 04-313, CC Docket No. 01-338), October 4, 2004.

Declaration with Dr. Kahn[2]—that ARMIS data includes DSL revenue but not DSL lines, thus overstating the growth in revenue per line during periods when DSL revenue was growing rapidly.

II. Removing DSL Revenue from ARMIS Special Access Revenue

8. I took ARMIS data on DSL revenue for Verizon for 2002 and 2003 from row 4012 of the ARMIS Report 43-04. I conservatively assumed that the annual growth rate for those years applied to all previous years.[3] I then subtracted these DSL revenues from ARMIS special access revenue and divided the difference by VGEs. The results are shown in Table 1, where both nominal (current dollar) and real (constant dollar) annual growth rates are calculated for the periods before and after special access pricing flexibility began.[4]

TABLE 1
VERIZON SPECIAL ACCESS REVENUE PER LINE

		Nominal Annual Growth	Real Annual Growth
All Data 1996 – 2003	Previous Excl DSL	-9.9% -12.7%	-12.0% -14.6%
Before Pricing Flexibility 1996-2000	Previous Excl DSL	-10.7% -11.8%	-12.7% -13.8%
During Pricing Flexibility 2001-2003	Previous Excl DSL	-11.7% -20.7%	-13.4% -22.2%

9. Removing the DSL revenue from the ARMIS special access revenue corrects the problem noted in my previous Declaration in this docket and my 2002 Declaration with

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[2] Declaration of Alfred E. Kahn and William E. Taylor on Behalf of BellSouth Corporation, Qwest Corporation, SBC Communications, Inc., and Verizon, *In the Matter of AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services* (RM No. 10593, December 2, 2002) ("*Kahn-Taylor Declaration*").

[3] The assumption is conservative because (i) DSL is a new service, and annual growth rates would be expected to fall over time and (ii) overstating DSL revenue in the early years has the effect of reducing special access revenue in the early years, which increases its rate of growth over time. In addition, DSL revenue was $0 before 1998 because Verizon did not provide the service. DSL revenue was also set to $0 for 2001 because merger conditions required that it be provided through an affiliate and little or no DSL revenue was reported in ARMIS that year.

[4] "Nominal" revenue per line is measured in current dollars and thus includes the effects of inflation. "Real" revenue per line is measured in constant (1982-1984) dollars which removes the effects of inflation—as measured by the Bureau of Labor Statistics Consumer Price Index —from the numbers.

Professor Kahn: that DSL revenue is included in the ARMIS reports as special access revenue, but DSL lines are not included in the ARMIS reports as special access lines. Since DSL revenue and lines have been growing rapidly, including DSL revenue but omitting DSL lines overstates special access revenue and overstates it more in recent years. This overstatement has the effect of understating the rate of reduction of average revenue per line. Excluding DSL revenue then has the expected effects: average revenue per VGE falls faster with DSL revenue excluded and the difference is greater in the later period when DSL revenue is larger.

III. AT&T's Criticisms of Average Revenue per VGE are Unfounded

10. AT&T (at 107-108) offers three arguments why the Commission should not accept the reduction in average revenue per VGE as evidence of price reductions. Each of these arguments is incorrect.

A. Average revenue per VGE declined faster under pricing flexibility

11. First, AT&T claims that the reductions in price were a result of price cap regulation and predated pricing flexibility in 2002. In fact, between 1996 and 2001, average revenue per VGE fell faster than required by the price cap regime. Moreover, as shown in my previous Declaration, average revenue per VGE fell significantly faster after 2001 than before.

12. The data shown above in Table 1 contradict AT&T's claims. First, the 13.8% real annual reduction in average revenue per VGE before pricing flexibility began for special access (1996-2000) far exceeds the maximum real rate reduction imposed by price cap regulation (6.5% at the end of the period). Thus, even during the price cap period, the annual price cap real rate reductions were not large enough to account for the observed reductions in average revenue per VGE. Second, the data in Table 1—as well as the data in Table 1 of my previous Declaration—show clearly that average revenue per VGE fell much faster in the 2001-2003 period (when special access pricing flexibility was available) than during the 1996-2000 period before pricing flexibility was available.

13. Thus, the explanation for the observed decline in average revenue per VGE is not price cap regulation.

B. Fully distributed costs and accounting earnings cannot be used to assess prices

14. AT&T (at 107) cites its previous assertions that the average revenue per VGE analysis ignores the fact that average expense per line has fallen and that "the Bells' net return, on a DS0 equivalent basis, [has] increased enormously." That this claim has any bearing on the level of Verizon's special access prices is economic nonsense, as Dr. Kahn and I pointed out almost two years ago:[5]

> This is a truly outrageous claim, relying as it does on measures of fully allocated book costs of services whose production in common with others entails a very high proportion of fixed and common costs and significant economies of scope—all the more so coming from a company and specific witnesses who have consistently and correctly decried the basis for such claims in economic terms for many decades...
>
> High or increasing rates of return calculated using regulatory cost assignments for interstate special access services do not in themselves indicate excessive economic earnings reflecting the exercise of market power. Indeed, regulatory rates of return for geographic subsets of single services in multi-product, multi-geographic firms bear no relationship with economic profits and thus can serve no useful purpose in determining whether pricing flexibility has or has not been excessively permissive. ILECs are integrated multi-regional firms and rely on an integrated regional management structure employing the regional physical and human resources to provide a multiplicity of services. The cost allocations required render such a calculation meaningless. ...
>
> The regulatory expedient of assigning fixed costs among categories (e.g., between regulated and unregulated or between interstate and intrastate jurisdictions), in proportion to variable costs or demand volumes, though "reasonable," is not cost-causative, and the resulting costs are not economic costs. It might be equally reasonable to allocate railroad overhead costs to services by volume, weight or value, but shippers of feathers, coal and diamonds would undoubtedly disagree about the results. In Dr. Willig's prophetic words some 15 years ago,
>
> > Fully allocated cost figures and the corresponding rate of return numbers simply have zero economic content. They cannot pretend to constitute approximations to *anything*. The "reasonableness" of the basis of allocation selected makes absolutely no difference except to the success of the advocates

[5] *Kahn-Taylor Declaration* at 7-9.

> of the figures in deluding others (and perhaps themselves) about the defensibility of the numbers. There just can be no excuse for continued use of such an essentially random, or, rather, fully manipulable calculation process as a basis for vital economic decisions by regulators.[6]

15. Moreover, AT&T's use of accounting earnings here contradicts its previous filings with regulators when asking for regulatory relief for its long distance services. In Massachusetts, AT&T argued that it

> ... is an integrated, multijurisdictional company providing telecommunications services worldwide using an integrated national management structure and employing the same physical and human resources to provide international, interstate and intrastate services. Because AT&T's services used the same network, computers and other facilities whatever the jurisdiction, determining a cost basis for calculating an economically meaningful rate of return is impossible. Rationally determining the cost basis for purposes of pricing individual state subsets of those services is also an economically impossible task. Yet, Massachusetts ROR regulation requires that a fully-allocated cost basis be established and that the prices for AT&T's intrastate services be modified to reflect such cost allocations. Allocating AT&T's multistate costs to determine AT&T's Massachusetts costs, further allocating those costs between interstate and intrastate services, and yet further allocating the intrastate costs among numerous intrastate services is economically irrational as a basis for setting prices. There is no rational basis for believing that rates based on fully allocated costs are either fair or economically justified.[7]

It is just as "economically irrational" to use accounting earnings and fully distributed costs to assess special access prices as to assess long distance prices.

16. Before the FCC, AT&T addressed assertions of high and increasing price-cost margins in long distance with the argument that "[w]ith respect to the increase in the price-cost margin, ... it should be expected that prices would be above marginal cost in a

[6] W. J. Baumol, M. F. Koehn and R.D. Willig, "How Arbitrary is 'Arbitrary'? – or, Toward the Deserved Demise of Full Cost Allocation," *Public Utilities Fortnightly*, Vol. 120, No. 5, September 3, 1987 at 21.
[7] Initial Brief of AT&T Communications of New England, Inc., dated April 23, 1992, in the Commonwealth of Massachusetts Department of Public Utilities proceeding DPU 91-79, at 42-43. Citations omitted. Quoted in *Kahn-Taylor Declaration* at 8.

market with high fixed costs."[8] The technology of special access loops and transport is certainly as subject to "high fixed costs" as that of long distance. AT&T's (correct) explanation of high and increasing price-cost margins in the long distance market is thus at odds with its complaints in the current proceeding about special access accounting costs and price-cost margins.

C. The shift in the mix of special access services does not account for the reduction in average revenue per VGE

17. AT&T claims (at 107-108) that examining average revenue per VGE "is fundamentally misleading," because any change in average revenue per VGE is "likely due principally to a changing mix of services," from lower to (relatively cheaper) higher capacity services.

18. First, measuring changes in average revenue per line on a DS0 equivalent basis is hardly "misleading" as evidence of price reductions. For years, AT&T argued that reductions in its average revenue per minute constituted price reductions for long distance for the purposes of (i) assessing competition to support its non-dominance petition and (ii) asserting that it had passed through carrier access charge reductions by lowering prices.[9] These arguments sharply contradict AT&T's claims in the current case.

19. Surely if reductions in average revenue per minute in the long distance market imply that prices have decreased, then a more dramatic drop in average revenue per VGE in the special access market must do the same. In the long distance markets, competition led to increases in base rates, similar to those of which AT&T complains today in the special access markets. However, in special access—as in long distance—these base rate increases were offset by a proliferation of volume and term discount plans that had the effect of reducing carriers' average revenue per minute. The fact that some special access tariff rates have risen while term and volume discount plans have caused average revenue per VGE to fall is not an unprecedented event.

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[8] In re: *Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, Order, released October 23, 1995 at ¶ 76 (footnotes omitted).

[9] *Ibid.*

20. In any event, lower average revenue per VGE represents a lower price that the special access customer pays for the VGE whether or not (i) the carrier has actually reduced the price of some service or introduced a new term and volume discount plan or (ii) the customer has chosen a higher capacity service at a lower price per VGE. If competition or additional consumer choice brings about lower average revenue per VGE for any of these reasons, consumers are better off.

21. Second, there is supporting evidence that contradicts AT&T's claim that the reduction in average revenue per VGE can be attributed principally to a shift in the mix of services purchased. In its initial filing in this proceeding, Verizon undertook such a study for its DS1 service, the service for which AT&T claims (at 106) that prices have increased under pricing flexibility.[10] The Verizon study calculated revenue from DS1 channel terminations, channel mileage and all other rate elements, summed those revenues and divided the sum by the number of DS1 channel terminations. The resulting average revenue per DS1 channel termination fell at an annual rate of about 4.1 percent between January 2001 and April 2004. In real (inflation-adjusted) terms, DS1 prices fell at an annual rate of 6.5 percent. These reduction include the effects of price changes and the migration of customers between tariffed services and volume and term discount contracts, but they do not include any effect of migration to higher-capacity services. As AT&T observed in its Comments (at 108) in criticizing the average revenue per VGE measure, the "more appropriate comparison, however, is to compare rates for the same service." Verizon has done exactly that.

22. Finally, AT&T's criticism that the declining average revenue per VGE is "likely due principally" to the change in the mix of services is pure speculation. In theory, a shift in the mix of services towards higher-capacity, lower price per VGE services would have the effect of lowering average revenue per minute, but AT&T presents no evidence regarding the *magnitude* of the shift towards high capacity services or the effect of that shift on average revenue per VGE.

[10] Declaration of Judith K. Verses, Ronald H. Lataille, Marion C. Jordan and Lynelle J. Reney, at ¶ 61.

23. In fact, Verizon data imply that the magnitude of the shift towards high capacity services is small. Table 2 shows the change in the distribution of Verizon special access channel terminations (measured in VGEs) across bandwidths from January 2002 to September 2004.

TABLE 2 VERIZON SPECIAL ACCESS DEMAND SHIFTS		
	JAN-02	SEPT-04
DS0-DS1	25.7%	21.9%
DS3-OCn	74.3%	78.1%

The effect of this change is modest, compared with the 21 percent annual drop in average revenue per VGE. If DS3-OCn services were priced at one-tenth that of DS0-DS1 services, the effect of the shift to cheaper services would be a reduction of about 4.0 percent per year in average revenue per VGE. A quick calculation shows that no matter how much cheaper per VGE the higher capacity services might be, the consequential reduction in average revenue per VGE can be no more than 5.9 percent per year. AT&T's unquantified assertion that the observed 21 percent annual reduction in average revenue per VGE is due "principally" to the shift in demand rather than reductions in price is not correct. More to the point, the drop in average revenue per VGE is utterly inconsistent with AT&T's picture of rampant price increases during the price flexibility period, notwithstanding the shift in demand to higher-capacity services.

24. This concludes my declaration.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on October 15, 2004

William E. Taylor

Dr. William E. Taylor
NERA