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
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DECLARATION OF MICAEL R. LIEBERMAN AND ROBERT PANERALI ON BEHALF OF AT&T CORP.

I. QUALIFICATIONS AND BACKGROUND.

1. **Michael R. Lieberman.** My name is Michael R. Lieberman. I am a District Manager in AT&T Corp.'s ("AT&T") Law and Government Affairs organization. In this position I am responsible for providing financial and industry analysis support relating to the costing and pricing of local telecommunications services. I was AT&T's primary participant in the development of the HAI/Hatfield Model of forward looking economic costs of local exchange networks and services and have been responsible for evaluating other costing models and methodologies such as the BCPM and the Federal Communications Commission's ("Commission's") Synthesis Model. I have a Bachelor's degree in mathematics and a Master's degree in statistics from the State University of New York at Stony Brook. Prior to joining AT&T as a statistical consultant in 1978, I was a bio-statistical consultant with Carter-Wallace of Cranbury, New Jersey.

2. Robert Panerali. My name is Robert Panerali. In my position as Senior Specialist, AT&T Consumer Finance, I am responsible for tactical domestic dial pricing, competitive offer tracking and special projects affecting domestic dial services. I joined AT&T in April 1982 and

have served in the Cost and Rates organization as well as in the Marketing and Finance organizations within AT&T. I am the person primarily responsible for tracking and analyzing competitive domestic dial prices. My responsibilities also include managing the acquisition of competitive price data, database development, and comparisons of competitive offers to AT&T plans. I graduated from the University of South Florida in 1976 with a Bachelors degree in Economics. I received a Masters degree in Economics from the University of Illinois in 1978 and a Ph.D. in Economics from the University of Illinois in 1982.

II. PURPOSE OF TESTIMONY.

3. The purpose of our testimony is demonstrate the ease with which incumbent local exchange carriers ("ILECs" or "incumbents") can swiftly implement changes to their rate structures from one that may allow competition to one that does not, and to identify several situations where this has already occurred. Specifically, we focus on recent pricing behavior of SBC and its affiliates ("SBC"). SBC, after having gained authority from the Federal Communications Commission ("Commission") to provide long-distance service throughout its entire local telephone service areas, implemented new rate structures to both its local and long-distance service offerings that – almost overnight – blocked competitive entry.

4. As we detail below, last year, SBC reduced its retail long-distance rates – *i.e.,* the rates that competitors must match in order to compete against SBC for long-distance customers. But SBC continued to charge its competitors inflated rates for access to SBC's local networks – a cash charge that long-distance carriers must pay to provide long-distance services, but that is only a phantom intra-company accounting entry for SBC. SBC's inflated access rates made it economically infeasible, in many states, for competitors to match SBC's newly reduced retail long-distance rates. SBC thus successfully implemented a classic "price squeeze." That is, SBC charged lower retail rates than its competitors could rationally charge given the inflated rates that

SBC requires its rivals to pay for access to SBC's bottleneck local telephone network. SBC also used this scheme to cement its local telephone monopolies by requiring end-user customers to purchase SBC's local telephone services in order to obtain the massive long-distance discounts.

5. As discussed below, it can be difficult to detect and respond to such anticompetitive price squeezes. However, we were able to identify several clear instances where SBC implemented a price squeeze. Due to the blatant nature of these identified squeezes, others undoubtedly exist.

6. The remainder of this declaration is organized as follows. Part III of this declaration describes the long distance market and shows how incumbents, like SBC, can implement price squeezes. Part IV of this declaration describes the various strategies employed by SBC to set its access and retail rates at levels that, almost overnight, effected price squeezes that made competition economically unviable.

III. INCUMBENTS HAVE THE ABILITY TO IMPLEMENT UNLAWFUL PRICE SQUEEZES AGAINST LONG-DISTANCE AND LOCAL TELEPHONE RIVALS.

7. Traditional long-distance carriers own "long-haul facilities" designed to carry traffic between local telephone networks. The local telephone networks are owned by ILECs. SBC and the other ILECs own most of these local telephone networks. According to a recent Commission study, the ILECs' local telephone market share is about 84%. *Local Telephone Competition: Status as of December 31, 2003*, Industry Analysis and Technology Division Wireline Competition Bureau (rel. June 2004) ("FCC Competition Report").[1] Long-distance

[1] Available at http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/lcom0604.pdf. The report further shows that the percentage of CLEC lines that are facilities based is 23.5% Thus, the percentage of total lines that are carried by a CLEC's own facilities is under 4% (*i.e.*, 16% CLEC share multiplied by the 23.5% of CLEC lines that are facilities based).

carriers therefore must obtain access to ILEC-owned local telephone networks in order to handle long-distance customers' calls.

8. The ILECs charge long-distance companies for access to their local networks. When a long-distance call is placed by a customer, the call "originates" on the local network and is carried by the owner of the local network (usually one of the ILECs) to the long-distance carrier's long-distance network. The fee paid by the long-distance carrier for this service is called an "originating access charge." The call then travels over the long-distance carrier's long-haul network to the local network where the recipient of the call is located. The call is then handed off (or "terminated") to the owner of that local network (again, usually an ILEC), and the call is then routed to the intended recipient of the call. The fee paid by long-distance carriers for this service is called a "terminating access charge."

9. Simply put, long-distance carriers usually must purchase originating and terminating access from ILECs each time the long-distance carrier completes a call for one of its customers. The Commission regulates access charges for interstate calls, and states regulate access charges for intrastate long-distance calls. And, notwithstanding that there are no economic or technical differences between the access services provided to a long-distance carrier for calls that begin and end in different states (interstate calls) compared to calls that begin and end in the same state (intrastate calls), charges for intrastate access are usually substantially higher than the already inflated interstate access charges. This is significant because the size and population distribution within large states, *e.g.,* Texas, California and Florida, means that a large percentage of long distance calls originate and terminate in the same state, allowing the local telephone companies to exact the higher intrastate access rates on long-distance carriers.

10. Interstate and intrastate access charges substantially exceed any measure of the local telephone network owners' economic cost of providing these services.[2] For example, *inter*state access rates in SBC's region are, on average, two-times higher than the state-approved cost estimates for the analogous UNE facilities. And SBC's *intra*state access rates (which obviously vary by state) are, on average, about two and one half times higher than even the interstate access rates.

11. Although local telephone companies have always overcharged long distance carriers (and thus long-distance customers) through access rates, those charges have historically had a moderate impact on long-distance competition because *all* long-distance carriers had to pay those charges. The playing field was level among long-distance carriers. That changed, however, when the Commission authorized the largest ILECs – the Baby Bells – to enter the long-distance markets nationwide. Although the long-distance affiliates of the Bells are nominally expected to pay their parent companies the same access charges paid by other long-distance companies, that is nothing more than a transfer of funds from the Bell Holding Companies' right pocket to left pocket. The economic reality is that the Bells incur only their actual economic cost of providing access to their local networks, whereas long-distance companies incur the above-cost access rates as a real cash cost.

12. Simply put, the competitive playing field in the long-distance markets is no longer level. The Bells have a substantial cost advantage over other long-distance carriers in the provision of long-distance services because, as noted, for in-region traffic, the Bells incur only cost-based local network access charges, and their rivals pay the Bells' bloated access charges.

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[2] No one, not even the ILECs, seriously dispute that access charges are above cost. *See, e.g., Ex Parte Letter* from Colleen Bothby to Marlene H. Dortch, RM No. 10593, v-vii, 27-40 (filed Aug. 26, 2004) (showing that special access rates far exceed the ILECs' cost of providing special

It is this market distortion that allows the Bells to implement price squeezes against their rivals by enabling their long distance affiliates to charge a price for long distance services that would not be economically feasible for their competitors to match.[3]

13. The only way to avoid this price squeeze is for long-distance carriers to avoid the ILECs' inflated access charges is by "winning" an end-user customer's *local* telephone business as well as the customer's long-distance business. But history confirms that such competitive success is not economically likely. As noted, long-distance and other local competitors serve less than 4% of end-user customers with their own facilities. And, although competitors had some initial success competing for local customers using unbundled network element platforms ("UNE-P") purchased from the ILECs, the future availability of UNE-P is tenuous, at best.

14. It is critical to recognize, however, that even in the few instances where long-distance carriers have won a customers local telephone business, the long-distance carrier avoids

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access).

[3] The Commission has long recognized that this situation gives the Bells the ability to "price squeeze" long distance rivals.

> The incumbent LEC could do this by raising the price of interstate access services to all interexchange carriers, which would cause competing in-region carriers to either raise their retail rates to maintain their profit margins or to attempt to maintain their market share by not raising their prices to reflect the increase in access charges, thereby reducing their profit margins. If the competing in-region, interexchange providers raised their prices to recover the increased access charges, the incumbent LEC's interexchange affiliate could seek to expand its market share by not matching the price increase. The incumbent LEC affiliate could also set its in-region, interexchange prices at or below its access prices. Its competitors would then be faced with the choice of lowering their retail rates for interexchange services, thereby reducing their profit margins, or maintaining their retail rates at the higher price and risk losing market share.

Access Reform Order, 12 FCC Rcd. 15982, ¶ 277 (1997). *See also LEC Classification Order*, 12 FCC Rcd 15756, ¶ 83 (1997) (a local exchange carrier "can profitably raise and sustain prices above competitive levels and thereby exercise market power . . . by increasing its rivals' costs or by restricting its rivals' output through the carrier's control of an essential input, such as access to bottleneck facilities, that its rivals need to offer their services").

only originating access charges for these customers, and still must pay *terminating* access charges for most long-distance calls placed by these customers because most other local subscribers (to whom the customers' calls would be placed) are Bell or other ILEC local telephone subscribers. AT&T, for example, provides local telephone service to only **Begin Confidential *** *** End Confidential** of its residential long-distance customers. That means that on average **Confidential *** *** End Confidential** of calls made by an AT&T customers will be terminated by another carrier, usually SBC or another ILEC, and thus AT&T will be subject to terminating access charges. Simply put, even where long-distance carriers manage to win a local telephone customer's business, the long-distance carrier avoids only a portion of the inflated access rates (originating access charges, but not terminating access charges).

15. It is also important to recognize that an ILECs' ability to implement a price squeeze increases in larger states. That is because a greater percentage of "large state" calls begin and end in the same state (*e.g.,* calls from Dallas to Houston or from Los Angeles to San Francisco), which means that, in these larger states, long-distance carriers are subject to the much higher *intra*state access charges more frequently. Many of the states served by SBC are very large with dispersed populations, thus providing SBC with substantial incentives to and the ability to implement price squeezes.

16. Finally, it is very difficult for competitors and regulators to respond to price squeezes once regulation creates an environment where they can be implemented. That is because price squeezes can be very difficult to detect. SBC and other ILECs can implement price squeezes by lowering retail long-distance rates, increasing originating or terminating access

charges, or by re-balancing both retail rates and access charges. Thus, detecting such behavior and identifying a price squeeze before it has its anticompetitive effect can be extremely difficult.

IV. SBC HAS, IN FACT, IMPLEMENTED STRATEGIES THAT EFFECT PRICE SQUEEZES AGAINST ITS LONG-DISTANCE AND LOCAL TELEPHONE RIVALS.

17. As noted, SBC has in fact implemented price squeezes against its long-distance rivals, including AT&T. After SBC was granted authority to provide long-distance telephone service throughout most of its local telephone service areas, SBC quickly acquired a substantial share of mass market long-distance customers by charging rates that were generally competitive with prevailing long-distance carriers' prices by exploiting its approximately 75-90% share of local service customers. In March 2003, however, SBC began offering plans long-distance service plans at rates that were much lower than the lowest then-prevailing long distance rates *and* that SBC offered *only to local service customers of SBC.* SBC called these new lower prices "promotional."

18. AT&T determined that it could not match many those substantial price reductions given the charges that AT&T must pay for access to SBC's local telephone customers. Specifically, AT&T determined that, in most states where SBC was offering the promotion, SBC's access charges inflated AT&T's total costs of providing stand-alone long-distance service to levels above SBC's promotional rates. Even where AT&T served the local customer, AT&T still could avoid only originating access charges and still had to pay SBC's bloated terminating access charges. Simply put, the cost advantages associated with owning the local telephone network allowed SBC to reduce its costs to levels that AT&T could not match. AT&T was suffering a price squeeze.

19. For example, one of SBC's promotions cut its per minute flat rate to levels that were effectively 58% below prevailing market rates. SBC also implemented promotions offering

a fixed fee for up to 60, 200 and 500 minutes of calls each month, respectively. These new rates undercut the then-prevailing market rates by 47%, 55%, and 56% for typical customers purchasing 60, 200, and 500 block of time plans, respectively.[4] AT&T's margins – the difference between its prices and costs – of course were well below **Begin Confidential ***** ***** End Confidential** and, thus, it was not economically feasible for AT&T to try to match those prices while paying SBC's current access charges.

20. It turned out, of course, that SBC's rates were hardly "promotional." Those rates remained in effect for an entire *year*. And, as a result of SBC's so-call "promotional" pricing plans and access charges, SBC is now the dominant provider of long-distance and all-distance services in the SBC Territories. In less than a few years, SBC went from a zero market share to having the largest share of the market of any carrier that offers mass-market long-distance or all-distance services in the SBC Territories. Indeed, SBC reports that its long-distance market penetration (for retail and enterprise customers) is now over 43%. *See, e.g.,* SBC 2nd Quarter 2004 Earnings Slide Show, p. 8.[5] Likewise, despite the hopes that the 1996 Act would open local markets to effective competition, SBC has maintained its dominant position in the local markets, with market shares of approximately 75-90% in most states in the SBC franchise footprints.

21. Although SBC increased its supposedly promotional rates after a year, SBC implemented another price squeeze strategy to ensure that any customer that tried to leave SBC after the rate hike would not go to a competitor. Specifically, SBC instituted a "win back" program in which it offered special very low prices to customers that returned to SBC after

[4] SBC's promotions varied slightly by state, but the promotions discussed here were available in most states throughout SBC's local telephone region.

[5] Available at http://www.sbc.com/gen/investor-relations?pid=282.

leaving for a different long-distance carrier. SBC's win back program offers discounts similar to those of the promotional plans to any customer that recently switched from SBC to a competitor. In other words, for the customers that were unwilling to accept SBC's rate increases at the end of the promotional period, and that sought to switch to a competitor, SBC offered special rates similar to SBC's previous promotional rates. Not surprisingly, AT&T cannot generally match SBC's win back rates due to the excessive access charges that AT&T must pay to SBC. Further, even aside from SBC's winback offerings, SBC also has implemented generally available rates that continue to be well-below levels that permit competition.

22. AT&T likely still has not identified all of SBC's price squeeze schemes. As noted, many of the win-back rates are offered to customers in very discrete ways, such as direct mail, direct telephone marketing, and during service calls from customers. And the discounts take many forms that are also difficult to measure. These include free months of service, airline miles, calling card minutes, giveaways (e.g., TVs, phones, etc.), and so on. In this regard, it is not only difficult to determine whether SBC is offering additional discounts, but it is also difficult to measure the size of those discounts.

23. SBC has effectively admitted that its pricing schemes are designed to drive competitors out of the markets so that SBC can ultimately increase prices. As the Wall Street Journal reported after SBC cut certain rates to $8:

> SBC Chief Operating Officer Randall Stephenson has [explained]: 'If I keep this customer [with promotions], I'm going to get $28 in the future and that's a lot better than $14 [for UNE-P].' The promotion in Michigan ends after a year, and rates jump to $28 a month for the same plan, he says. (That price isn't disclosed on the flier, but a company spokesman said it is told to consumers who call to sign up.) [6]

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[6] Wall Street Journal, Bells Mount Two-Way Assault on Local Market – New-Client Perks Pressure Rivals, Who Also Face Rise In Rates for Using Network, Anne Marie Squeo (Aug. 3,

24. Finally, it is important to emphasize that SBC's long-distance price squeeze strategies are also hampering competition for local telephone customers. As noted, SBC's discounts to its long-distance services are tied to the purchase of SBC's local telephone service. A customer that purchases local telephone service from another carrier is thus not eligible for SBC's below market prices for long-distance service. SBC's long-distance price squeeze thus cements its stranglehold over local markets. Competitors cannot match SBC's long-distance rates, and it is not economically feasible to make up the difference with lower local rates. SBC's anticompetitive conduct thus has far-reaching consequences that go beyond killing its long-distance competitors.

25. SBC's strategy is well summarized by a recent Wall Street Journal Article:

> [s]ome of these offers amount to free phone service for a few months, rivals contend. In Michigan, for example, SBC is offering residential customers a five-month $7.95 special for unlimited local calling that includes caller identification and call waiting, if they'll return. In the past few weeks, the company has added 30 minutes of free long-distance service to the promotion. After the promotion ends, the price would jump to $17.95, which is still 36% below the $28 to which SBC is asking Michigan regulators to boost its wholesale rate.[7]

2004).

[7] *Id.*

VERIFICATION

I declare under penalty of perjury that the foregoing is true and correct.

October 4, 2004.

/s/ Michael R. Lieberman

Michael R. Lieberman

VERIFICATION

I declare under penalty of perjury that the foregoing is true and correct.

October 4, 2004.

/s/ Robert Panerali

Robert Panerali