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December 8, 2004

Ex Parte

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

**Re: Unbundled Access to Network Elements, WC Docket No. 04-313;
Section 251 Unbundling Obligations for Incumbent Local Exchange
Carriers, CC Docket No. 01-338**

Dear Ms. Dortch:

Verizon is submitting the attached white paper to respond to AT&T's latest claims regarding special access price. We also are submitting a declaration of William E. Taylor that responds to criticisms of his previous work, which found that Verizon's special access average revenue per line fell sharply over the 1996-2003 period and fell even more dramatically during the pricing flexibility period from 2001 to 2003.

Please include the attached redacted version of this filing in the record of these proceedings.

All inquiries relating to access (subject to the terms of any applicable protective order) to the confidential information submitted by Verizon should be addressed to:

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Sincerely,



Attachment

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**THE EVIDENCE DEMONSTRATES THAT CLECs ARE COMPETING SUCCESSFULLY
USING SPECIAL ACCESS, THAT SPECIAL ACCESS PRICES ARE FALLING, AND THAT
THERE IS NO LEGITIMATE THREAT OF RISING PRICES OR A PRICE SQUEEZE**

This White Paper responds to AT&T's latest claims regarding special access prices.¹ While AT&T continues to argue that special access prices are too high to offer a viable competitive alternative to high-capacity UNEs, the facts show just the opposite.

As Verizon demonstrated, although competing providers are relying heavily on their own or alternative facilities to provide high-capacity services, they also are filling in gaps and extending the reach of those facilities by using special access services purchased from ILECs. Competing providers, both large and small, are in fact using special access to serve customers of all shapes and sizes, and in all geographic markets.² For many of the retail services that competing carriers are providing using special access – such as packet-switched data services like Frame Relay and ATM – competing carriers already account for a dominant share of revenues.³ And in downstream markets such as wireless and long distance – where special access is used by carriers to transport switched traffic that is consolidated from many smaller customers – competition is thriving to an unprecedented degree.⁴ Indeed, Verizon's own high-capacity business is overwhelmingly a wholesale business. Approximately 85 percent of Verizon's DS1 special access services and 84 percent of Verizon's DS3 special access services are sold on a wholesale basis to other carriers, with the remainder sold at retail.⁵ And the wholesale special access business is continuing to grow while the retail business is not.⁶

Verizon also demonstrated that the prices that customers actually pay for special access service have been steadily declining, which is due to the extensive competition for these services. Since the BOCs have been granted pricing flexibility, their average revenue per voice-grade-equivalent ("VGE") special access circuit has declined by an average of 20 percent per year, net of inflation. *See* Taylor Ex Parte Decl. ¶ 5 & Table 1 (Attachment 1). These declines have occurred not only with respect to the higher tiers of special access service, but also with respect to the lower tiers, such as DS1 services, which have fallen by an average of 6.5 percent per year, net of inflation, under pricing

¹ *See* Ex Parte Letter from C. Frederick Beckner, III, Sidley & Austin, to Marlene Dortch, FCC, CC Docket Nos. 01-338, 96-98, 98-147 (Nov. 8, 2004), attaching white paper entitled "The Evidence of Record Overwhelmingly Confirms that Wireline Competition Cannot Flourish If Competitive Carriers Are Relegated to Special Access Service" ("AT&T White Paper"), and Ex Parte Declaration of Lee Selwyn ("Selwyn Ex Parte Decl.").

² *See* Verizon Reply at 81-88; Verizon Comments at 39, 54-65; Nogay Decl. ¶¶ 19-26; Verses/Lataille/Jordan/Reney Decl. ¶¶ 51-60 & Exhs. 7A-B.

³ *See* Verizon Comments at 67-70; Bruno Decl. ¶¶ 13-24.

⁴ *See* Verizon Comments at 70-75.

⁵ *See* Verses/Lataille/Jordan/Reney Decl. ¶ 51 & Exh. 9; Nogay Decl. ¶ 23.

⁶ *See* Verizon Reply at 98; Lataille/Jordan/Slattery Reply Decl. ¶ 18.

flexibility.⁷ Moreover, average revenues per VGE have dropped faster under pricing flexibility (*i.e.*, 2001-2003) than under price caps (*i.e.*, 1996-2000).⁸

The evidence also shows that competing carriers have taken advantage of the falling prices and significant discounts that have become available as a result of pricing flexibility. When competing carriers purchase high-capacity services from Verizon, they overwhelmingly purchase those circuits as special access, not as UNEs. For example, competing carriers purchase more than 91 percent of their DS1 loops and more than 98 percent of DS3 loops from Verizon as special access.⁹

1. *AT&T's Claim That the Bell Companies Have the Ability To Raise Special Access Prices Is Not a Basis for a Lawful Impairment Finding and Is Wrong as a Factual Matter.*

AT&T argues that special access does not provide a viable alternative to high-capacity UNEs because of the supposed risk that Bell companies will raise their special access rates. AT&T claims that the Bell companies “have raised their special access rates in response to rate deregulation,” which, according to AT&T, shows that the Bell companies have the ability to do so again in the future. AT&T White Paper at 1. AT&T’s arguments are misplaced.

Pursuant to the D.C. Circuit’s decision in *USTA II*, concerns about special access prices cannot form the basis of impairment as a legal matter. Rather, the Commission can and must address those concerns directly, and it has in fact already done so both through regulation under price caps, and through deregulation pursuant to the framework established in the *Pricing Flexibility Order*.¹⁰ To the extent that AT&T claims that special access rates are or will become uncompetitive, the Commission may address those concerns in that pre-existing framework, not in this one. As the Court held, where, as here, the Commission has these “narrower alternative[s]” with “fewer disadvantages” available, it must use them. *USTA II*, 359 F.3d at 571. Any contrary approach would be “irrational” and inconsistent with the D.C. Circuit’s “admonition in *USTA I* that the Commission must balance the costs and benefits of unbundling.” *Id.* at 570. Thus, on this basis alone, AT&T’s claims must be rejected.

In any event, AT&T’s claim that special access prices have been increasing is wrong as a factual matter. *First*, AT&T takes issue with the fact that Verizon’s analysis uses the prices that competing carriers actually pay for special access, rather than the base

⁷ See Verses/Lataille/Jordan/Reney Decl. ¶ 61 & Exh. 15.

⁸ See Taylor Reply Decl. ¶¶ 8-9 & Table 1; Taylor Special Access Pricing Decl. ¶ 11 & Table 1; Taylor Ex Parte Decl. ¶ 5 & Table 1.

⁹ See Verses/Lataille/Jordan/Reney Decl. ¶¶ 51-59 & Exhibits 10A-10D, *attached to Verizon Comments at Attachment B* (corrected by Errata filed Dec. 7, 2004).

¹⁰ Fifth Report and Order and Further Notice of Proposed Rulemaking, *Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers*, 14 FCC Rcd 14221 (1999) (“*Pricing Flexibility Order*”), *aff'd*, *WorldCom, Inc. v. FCC*, 238 F.3d 449 (D.C. Cir. 2001).

rates contained in Verizon's tariffs. But the whole point of granting Verizon and other BOCs pricing flexibility was to enable them to deviate from these base rates and offer contract tariffs and more varied discounts.¹¹ And as Verizon demonstrated, competing carriers, including AT&T itself, are availing themselves of these discounts and typically purchase special access services from Verizon at discounts that are approximately 35 to 40 percent off the tariffed base rates for these services.¹² Any analysis of special access pricing in the wake of pricing flexibility obviously must take these facts into account.

Second, AT&T repeats its claims that the decline in revenues per VGE are due principally to the fact that higher capacity services, which have a lower effective price per VGE, are growing at a faster rate than lower capacity services. As an initial matter, the fact that demand is shifting to higher-capacity services and that the per-unit prices of those services are lower, shows that BOCs do not have the ability to constrain prices and restrict demand, as AT&T suggests. In any event, Verizon explained that the average price for DS1 circuits alone has declined during the pricing flexibility period, and that the price reductions carriers have received in recent years are too large to be explained solely by the changing mix of services.¹³

AT&T offers no response to Verizon's data on DS1 circuits, and focuses instead on Dr. Taylor's analysis of the changing mix of services. AT&T claims that Dr. Taylor improperly corrects for this changing mix by aggregating services into two broad categories – (1) DS0-DS1, and (2) DS3-OCn – that mask intra-category demand shifts. But even using Dr. Selwyn's own categorizations shows that shifts in demand account for no more than about 35 percent of the total decline in average revenue per VGE during the pricing flexibility period, while the remaining 65 percent is attributable to price declines. *See Taylor Ex Parte Decl.* ¶ 16.

Third, AT&T claims that most of the decline in the average revenue per VGE during the pricing flexibility period is due to mandatory rate reductions in the MSAs still subject to price-cap regulation. That is simply wrong. During the pricing flexibility period, the price-cap index was reduced by an average of only 4.88 percent per year. *See id.* ¶ 11. By contrast, average revenues per VGE across all MSAs fell by an average of 18.5 percent per year (before adjusting for inflation) during that same time period. *See id.* & Table 1. Thus, nearly three quarters of the reductions in average revenue per VGE that have taken place during the pricing flexibility period are not attributable to mandatory price-cap reductions and are instead reductions that ILECs made on their own initiative, in response to competitive pressures. *See id.* ¶¶ 11-12.

Fourth, AT&T claims that it was improper for Dr. Taylor to remove DSL revenues from the amounts used to calculate average revenue per VGE, because these revenues are not separately identified in Verizon's ARMIS filings and cannot be verified. But there can be no serious dispute that including these revenues skew the data – because

¹¹ *See Pricing Flexibility Order* ¶ 24.

¹² *See Verses/Lataille/Jordan/Reney Decl.* ¶ 60.

¹³ *See Verses/Lataille/Jordan/Reney Decl.* ¶ 61; *Taylor Reply Decl.* ¶¶ 17-23.

DSL lines are not included in the count – and must therefore be excluded. In any event, Dr. Taylor’s Ex Parte declaration provides the DSL revenues that he removed from the analysis, which were based on Verizon’s records.¹⁴ Dr. Taylor’s declaration also corrects his prior analysis to remove the DSL revenue from the former GTE and Contel companies to be consistent with the approach he took for special access revenue. *See* Taylor Ex Parte Decl. ¶ 5.¹⁵

Fifth, AT&T accuses Dr. Taylor of making “a basic computational error” that, when corrected, supposedly shows that Verizon’s average revenue per VGE declined faster under price caps than under pricing flexibility (but nonetheless still declined in both periods). AT&T White Paper at 2; Selwyn Ex Parte Decl. ¶¶ 10-12. But what AT&T characterizes as a computational error is nothing of the sort. The difference between Dr. Taylor’s and AT&T’s analyses is that Dr. Taylor excluded the former GTE companies (which Verizon did not acquire until mid-2000) from the analysis, whereas AT&T included these companies. *See* Taylor Ex Parte Decl. ¶ 10. In any event, even when the former GTE companies are included in the analysis, and when two other corrections are made (removing both DSL revenues and intrastate special access revenue), the data show that Verizon’s average revenue per VGE (before adjusting for inflation) declined by an average of 12 percent per year from 1996-2003, and declined faster in the pricing flexibility period (17.5 percent) than during the price-cap period (11.9 percent). *See id.* ¶ 6 & Table 3.

Finally, AT&T argues that, even assuming special access prices have declined, costs have declined even faster and that ARMIS data now show that Bell companies are earning an excessive rate of return for special access service. As Verizon has explained, however, such claims calculate BOC margins using ARMIS data, which the Commission has found “do[] not serve a ratemaking purpose.”¹⁶ ARMIS data are collected pursuant to cost-allocation rules that the Commission more than three years ago found were “outdated regulatory mechanisms that are out of step with today’s rapidly-evolving telecommunications marketplace,” and that are even more antiquated today.¹⁷

¹⁴ While AT&T also speculates that, because some DSL revenues are not included in ARMIS, it is possible that Dr. Taylor removed revenue that was never included in first place, this is not the case. The only data that Dr. Taylor removed are the DSL revenue data that Verizon includes as a part of special access revenue in ARMIS Report 4304. *See* Taylor Ex Parte Decl. ¶ 4.

¹⁵ Dr. Taylor also corrects his analysis to remove intrastate special access revenues for 2003. *See* Taylor Ex Parte Decl. ¶ 5.

¹⁶ Order on Reconsideration, *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637, ¶ 199 (1991).

¹⁷ Report and Order, *Jurisdictional Separations and Referral to the Federal-State Joint Board*, 16 FCC Rcd 11382, ¶ 1 (2001).

2. *AT&T's Claims That the Bell Companies Have The Ability to Engage in Price Squeezes Likewise Fail on Both the Law and the Facts.*

In addition to arguing that the Bell companies have the ability to raise their special access prices, AT&T also alleges that the Bell companies have the incentive and ability to engage in price squeezes “by changing retail rates to levels that remain profitable to the Bells but that rivals forced to use special access service cannot match.” AT&T White Paper at 1. This argument is irrelevant to the impairment inquiry as a legal matter, misguided as an economic matter, and wrong as a factual matter.

As with AT&T's claim regarding special access rates generally, concerns about a price squeeze are not a legitimate grounds for finding impairment. Rather, the Commission has repeatedly recognized that the appropriate venue to address price-squeeze claims is in a section 208 complaint proceeding.¹⁸ And where such “narrower alternative[s]” with “fewer disadvantages” exist, the Commission must use them. *USTA II*, 359 F.3d at 571. It is no answer to claim that unbundling helps mitigate the risk of a price squeeze, by ensuring that there is a lower wholesale rate in place. That same goal can be accomplished by ensuring that special access rates do not permit a price squeeze, without any of the concomitant disadvantages that result from unbundling.

Even assuming that the Commission were to address issues regarding special access prices in this proceeding, however, AT&T fails to prove that there is a legitimate risk of a price squeeze here. As Verizon has explained, the Supreme Court has held that “predatory pricing schemes are rarely tried, and even more rarely successful.”¹⁹ This is particularly true in regulated industries. In the seminal *Town of Concord* case, then-judge Breyer held that “where [an alleged monopolist's] prices are regulated at both the primary and secondary levels,” a price squeeze is not only significantly less likely to occur, but even when it does occur “is not ordinarily exclusionary.”²⁰ AT&T argues that *Town of Concord* does not apply, because “in the wake of pricing flexibility, the Bells are regulated at *neither* the wholesale (special access) *nor* the retail (enterprise service) levels.” AT&T White Paper at 4. But the applicability of *Town of Concord* does not turn on how much or what type of regulatory oversight an agency exerts with respect to a specific service, but rather on whether there is a regulator there in the first place to provide “an administrative remedy” to competitors that believe they are being harmed by the regulated entity.²¹ Thus, while the Commission has streamlined the regulation of

¹⁸ See, e.g., *Pricing Flexibility Order* ¶ 131 (“[C]oncerns about a potential price squeeze are best addressed in the context of a complaint filed under section 208 of the Act alleging that a rate charged pursuant to a contract tariff or volume or term discount is unreasonably low and thus violates section 201.”); Memorandum Opinion and Order, *Application by SBC Communications Inc., et al., for Authorization To Provide In-Region, InterLATA Services in California*, 17 FCC Rcd 25650, ¶ 156 & n.562 (2002) (“[T]he appropriate venue for the price squeeze allegation . . . is a complaint under section 208 of the Act.”).

¹⁹ *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986); Verizon Reply at 95.

²⁰ *Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 22 (1st Cir. 1990).

²¹ *Town of Concord*, 915 F.2d at 28. Cf. *Verizon Communications v. Law Offices of Curtis Trinko*, 124 S. Ct. 872 (2004) (“*Trinko*”).

many of Verizon's wholesale and retail services at issue – though not nearly to the extent that AT&T suggests²² – the Commission has done so only in circumstances where competitive forces will discipline prices, and regardless still retains jurisdiction to ensure that those rates are just and reasonable, which is all that matters.²³

Far from demonstrating that a price squeeze is likely to occur, AT&T's price-squeeze theory is nonsense as an economic matter. AT&T admits that there is no evidence that the Bell companies are pricing retail services below cost, yet claims that “the Bells’ enormous access cost advantage enables them to set a retail price that rivals cannot match while still earning substantial profits.” AT&T White Paper at 3. Regardless of whether a price-squeeze is accomplished using above- or below-cost pricing, however, it still requires a carrier to forego significant profits in the short term, based on the theory that those profits can be recouped later once competitors are driven from the market. *See* Taylor Ex Parte Decl. ¶¶ 20-22. But the notion that the Bell companies could drive AT&T and other competitors from the services at issue here – including services such as frame relay and private line – is absurd. AT&T is the nation's largest frame relay and private line provider;²⁴ there are many other competitors providing these services;²⁵ and competitors' share of these services has been steadily growing for years.²⁶

There also is no basis to assume that Bell companies would engage in a price squeeze in light of the regulatory safeguards in place and the risks of detection. The Commission has previously acknowledged that its regulations provide adequate projections in this regard, and has rejected analogous price-squeeze claims that AT&T has made in the past on this basis. For example, in the *Access Charge Reform Order*, the Commission rejected claims that “access charge rate levels create the condition for an anticompetitive price squeeze when a LEC affiliate offers interexchange services in competition with IXCs,” finding that “although an incumbent LEC's control of exchange and exchange access facilities may give it the incentive and ability to engage in a price

²² For example, Verizon has not received Phase II pricing flexibility for approximately 90 percent of its DS1 end-user channel terminations, and therefore does not have the ability to raise prices for those circuits.

²³ Recognizing the weakness of its arguments, AT&T claims that, even if *Town of Concord* “were on point,” it supports the retention of UNEs because, “if competitive carriers were unable to maintain antitrust suits because of the existence of regulation, the Commission would have a heightened responsibility to ensure that its regulatory regime protects competitive carriers.” AT&T White Paper at 4. But given that the BOCs already are subject to heightened regulation that goes well beyond what the antitrust laws require, *see Trinko*, 124 S.Ct. at 883, there should be *less* concern here than if the antitrust laws were the only protection against anticompetitive conduct.

²⁴ *See* David Dorman, Chairman and CEO, AT&T, presentation before the Credit Suisse First Boston Media and Telecom Week, at 5 (Dec. 11, 2003) (AT&T is the nation's “largest private line/frame relay/ATM provider.”); Verizon Comments at 70.

²⁵ *See* Verizon Reply at 102; Verizon Comments at 67-68, 69-70.

²⁶ *Compare* R. Kaplan, IDC, *U.S. Packet/Cell-Based Services Market Forecast and Analysis, 2000-2005* at Figure 9 (Mar. 2001) to M. Bowen, *et al.*, Schwab Soundview Capital Markets, *AT&T Corp.* at 3 (Jan. 21, 2004) (AT&T, MCI, and Sprint's combined market share for frame relay has grown from just over 71 percent in 1999 to nearly 79 percent in 2004.).

squeeze, we have adequate safeguards against such conduct.”²⁷ The Commission explained that the “requirement that incumbent LECs offer services at tariffed rates . . . reduces the risk of a price squeeze to the extent that an affiliate’s long distance prices would have to exceed their cost for tariffed services.”²⁸

These same rationales apply here. AT&T’s price-squeeze analysis focuses principally on Verizon’s long-distance affiliate, Verizon Select Services, Inc. (“VSSI”). VSSI purchases special access from another Verizon affiliate, Verizon Global Network Systems, which in turn purchases access from Verizon’s ILEC affiliates out of the same tariffs that are available to AT&T and other competitors. Thus, in all cases VSSI obtains access at terms that are no more favorable than those available to AT&T and other competitors. In fact, the price VSSI pays for access is higher than the rates available to competing carriers, because GNS marks up the price of access it obtains from the Verizon ILEC to cover GNS’s costs. In addition, VSSI itself provides retail services pursuant to tariff so that the Commission can readily ensure that VSSI’s retail prices are higher than its wholesale access costs. Indeed, AT&T’s own analysis shows that the access prices that VSSI pays are in fact lower than the retail prices it charges, which should be the end of the matter.²⁹

Because AT&T cannot demonstrate that VSSI’s retail prices are lower than VSSI’s access costs, AT&T tries to show that the access costs that AT&T itself pays are higher than VSSI’s retail prices. In particular, AT&T claims that the access costs it pays for two particular service configurations – long-distance private line services at both the DS1 and D31 level – are higher than the retail prices that VSSI charges for these services.³⁰ AT&T also claims that the access costs it pays for T3-based Frame Relay service are higher than Verizon’s retail price for this service.

As an initial matter, AT&T’s hand-picked examples are irrelevant to the ability of the typical CLEC to serve an average customer using special access circuits. For example, Verizon has demonstrated that the average price that competing carriers in its region actually pay for a DS1 circuit is **[Begin Proprietary]** **[End Proprietary]** per month, which includes the channel termination, mileage charges, and other associated charges (such as multiplexing).³¹ According to several CLECs, the average revenues that

²⁷ First Report and Order, *Access Charge Reform*, 12 FCC Rcd 15982, ¶ 278 (1997) (“*Access Charge Reform Order*”); see also Memorandum Opinion and Order, *Applications of Pacific Telesis Group Transferor, and SBC Communications, Inc. Transferee, For Consent to Transfer Control of Pacific Telesis Group and its Subsidiaries*, 12 FCC Rcd 2624, ¶ 53 (1997) (“Price discrimination . . . is relatively easy for [the Commission] and others to detect, and is therefore unlikely to occur.”).

²⁸ *Access Charge Reform Order* ¶ 279; see also Memorandum Opinion and Order, *Application of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee, for Consent to Transfer Control of Domestic and International Sections 214 and 310 Authorizations and Application to Transfer Control of a Submarine Cable Landing License*, 15 FCC Rcd 14032, ¶ 198 n.454 (2000) (same).

²⁹ See AT&T Benway et al. Decl. Atts. 1 & 2.

³⁰ See AT&T Benway et al. Decl. ¶¶ 79-86, 97, 101-102 & Atts. 1 & 2.

³¹ See Verses/Lataille/Jordan/Reney Decl. Exh. 15.

a carrier can earn using a DS1 circuit, by providing a variety of services over that circuit, is between \$500 and \$700 per month.³²

In any event, AT&T's showing is deeply flawed in a number of critical respects. *First*, the amounts that AT&T claims it actually pays for access are considerably higher than the amounts reflected in Verizon's records. According to AT&T, it pays an average of [Begin Proprietary] [End Proprietary] for each end of an interstate DS1 circuit that includes a channel termination plus six miles of local mileage charges. Verizon's data, however, show that, from January through September 2004, AT&T paid an average of [Begin Proprietary] [End Proprietary] for each DS1 circuit – [Begin Proprietary] [End Proprietary] for the channel termination and [Begin Proprietary] [End Proprietary] in local mileage charges. *See* Attachment 2. This total reflects the average amount of local mileage that AT&T obtains for a DS1 circuit, which Verizon's records show to be about [Begin Proprietary] [End Proprietary] miles. Thus, for a DS1 circuit with only six miles of local mileage, the local mileage component would cost approximately 45 percent less, or approximately [Begin Proprietary] [End Proprietary], making the total cost of the circuit approximately [Begin Proprietary] [End Proprietary] – or 30 percent less than AT&T claims.

AT&T's supposed access costs for a six-mile interstate DS3 circuit are even more inflated. AT&T claims that it pays an average of [Begin Proprietary] [End Proprietary] for a typical interstate DS3 circuit.³³ Verizon's data, however, show that AT&T pays an average of [Begin Proprietary] [End Proprietary] for such circuits – 47 percent less. *See* Attachment 2.

The amounts that AT&T claims it actually pays also are higher than the amounts that are available to AT&T under Verizon's tariffs – the same tariffs out of which VSSI is required to purchase access. Given that AT&T can avail itself of these rates going forward, its analysis – which is based on the rates that AT&T has historically paid – is simply irrelevant. Moreover, AT&T can – and in many cases already does – avail itself of even lower rates than those used in its example, by using a different and more efficient network configuration for providing private line services. AT&T's example assumes that it obtains a stand-alone DS1 or DS3 circuit. But when carriers provide long-distance private line services, they increasingly obtain DS1 or DS3 circuits on much higher-bandwidth SONET facilities. This is how VSSI itself often provides long-distance private line services to end-user customers. Under Verizon's tariffs, the cost of DS1 and DS3 circuits provided over SONET facilities is considerably less expensive than the cost of obtaining stand-alone DS1 and DS3 circuits.

³² *See* Nuvox Communications, *TRO Remand Presentation* at 4 (Nov. 2004), attached to Ex Parte Letter form Michael Pryor, Mintz Levin Cohn Ferris Glovsky and Popeo PC, to Marlene Dortch, FCC, WC Docket No. 04-313 & CC Docket No. 01-338 (Nov. 24, 2004) (“Nuvox average revenue is \$500 to \$700/per month. Cbeyond is \$500/per month.”).

³³ AT&T Benway et al. Dec. Exh. 1.

Second, AT&T's assumptions regarding the amounts that VSSI's customers pay for private-line service are flawed. Based on its unexplained analysis of VSSI's tariff, AT&T claims that VSSI's retail price for DS1 interstate private line service is **[Begin Proprietary]** **[End Proprietary]** per month assuming 100 miles of long-haul transport. In reality, the average price for the very same configuration under VSSI's tariffs – assuming the discount rates for which VSSI actually qualifies – is **[Begin Proprietary]** **[End Proprietary]** per month. *See* Attachment 3. In fact, based on the actual sales that VSSI made between August 2003 and August 2004, the average price that customers paid for DS1 interstate private-lines with between 100-125 miles of long-haul transport was over **[Begin Proprietary]** **[End Proprietary]** per month.

Taking either the actual prices that VSSI's end-user customers are paying, or the prices that customers would likely pay based on VSSI's tariffs, and comparing them to the amounts that AT&T currently pays for access, demonstrates that there is nothing close to a price squeeze here. According to Verizon's records, AT&T pays an average of **[Begin Proprietary]** **[End Proprietary]** for two ends of a six-mile interstate DS1 circuit. VSSI sells such circuits, together with 100 miles of transport, for more than twice that price.

Third, AT&T's price-squeeze analysis for T3-based frame relay service also contains a number of flaws. As an initial matter, this entire analysis is largely besides the point because very few customers use T3-based frame relay service – only 1 percent of frame relay ports are sold at the T3 level, and these ports account for less than 7 percent of frame relay revenues.³⁴ Most customers that use T3-based packet-switched services rely on other technologies, such as ATM.³⁵

In any event, while AT&T claims that the access costs it actually pays for a T3-based frame relay service (assuming a customer with 10 remote sites with 4 megabit ports supported by T3 access, which are connected back to a hub site via 2 megabit permanent virtual circuits) are **[Begin Proprietary]** **[End Proprietary]** in the Verizon North territory and **[Begin Proprietary]** **[End Proprietary]** in the Verizon South territory, AT&T acknowledges that Verizon makes the access component of these services available at much lower rates under its tariffs – **[Begin Proprietary]** **[End Proprietary]** in both Verizon South and Verizon North.³⁶ AT&T is, however,

³⁴ R. Kaplan, IDC, *U.S. Frame Relay Services Forecast, 2002-2007* at Tables 3 & 4 (Mar. 2003) (estimates for 2004). AT&T claims that the configuration it assumes “is becoming more common as customer applications require more bandwidth,” AT&T Benway et al. Decl. ¶ 97, but provides no proof of that. Most customers that require packet-switched broadband services of DS3-level and above use technologies other than frame relay, such as ATM, IP-VPN, and Gigabit Ethernet. *See, e.g.,* J. Bazinet, et al., JP Morgan, *U.S. Telecommunications: The Art of War* at 20 (Nov. 7, 2003) (“While Frame Relay continues to dominate the slower DS-1 market, ATM continues to capture more growth from higher speeds, typically DS-3 and above.”).

³⁵ *See, e.g.,* R. Kaplan, IDC, *U.S. ATM Services Forecast, 2002-2007* at Table 4 (Mar. 2003); R. Kaplan, IDC, *U.S. Frame Relay Services Forecast, 2002-2007* at Table 4 (Mar. 2003) (Total combined ATM/frame relay revenue of \$2.87 billion at DS3 or higher, of which ATM captures \$2.33 billion).

³⁶ AT&T Benway et al. Dec. Exh. 5.

permitted to obtain access on the same terms and conditions as contained in Verizon's tariff. Thus, even assuming AT&T is paying more than these rates – and AT&T provides no credible basis to believe that it is – this does not establish a price squeeze.

Finally, AT&T's price squeeze analysis must be rejected on independent grounds because AT&T does not show a lack of retail competition for the services at issue, or even that such competition is in decline. In fact, it provides no evidence at all about the state of competition for these services, and merely offers vague allegations that it has been having difficulty competing.³⁷ AT&T does not provide any data regarding its past or current customers and revenues for its services. Moreover, while AT&T admits it still is able to provide the services at issue where it has its own local facilities in place, AT&T fails to identify where those facilities exist (just as it has refused to provide any details about its network in this proceeding), and the extent to which it is able to rely on those facilities for the services at issue as compared to its reliance on special access. Thus, AT&T does not provide any of the kind of information that the Commission would need to evaluate whether the alleged price squeeze has doomed competitors to failure, or even whether it is having or is likely to have any anticompetitive effects.³⁸

3. *Competing Carriers Have Been Successful Using Special Access*

Verizon demonstrated that competing carriers are not only using special access extensively, but that they have been successful doing so. Verizon offered multiple examples of competitive carriers that rely predominantly or exclusively on special access and that are EBITDA positive, which is the metric that is widely used in the telecommunications industry for evaluating the financial success of a carrier.³⁹ Moreover, as demonstrated above, the average price that competing carriers in Verizon's region pay for a special access circuit is considerably lower than the average revenues these carriers are able to earn by providing a variety of services over that circuit.

³⁷ *See id.*

³⁸ AT&T takes issue with Verizon's showing that it is **[Begin Proprietary]** **[End Proprietary]**, while Verizon's wholesale business is growing as a result of competing carriers purchasing high-capacity services and reselling them together with their own retail services. *See* Verizon Reply at 98; Lataille/Jordan/Slattery Reply Decl. ¶ 18. AT&T claims that Verizon has failed to account for the fact that some customers are no longer purchasing service directly from Verizon, but instead are contracting with Verizon's long distance affiliates, and that Verizon appears to treat this as a loss of retail revenue and a gain in wholesale revenue. AT&T White Paper at 11. In fact, Verizon's analysis includes revenues earned from its long distance affiliates in both the retail and wholesale totals, but such revenues are so small compared to the overall totals that, even when they are removed, there is no material change to the analysis. For example, in the original analysis, retail revenues for high-capacity circuits as a whole (DS1 and above) accounted for **[Begin Proprietary]** **[End Proprietary]** percent of the total, whereas wholesale revenues accounted for **[Begin Proprietary]** **[End Proprietary]** percent. When Verizon's long-distance affiliates are removed, retail revenues account for **[Begin Proprietary]** **[End Proprietary]** percent of the total, whereas wholesale revenues account for **[Begin Proprietary]** **[End Proprietary]** percent.

³⁹ Verizon Reply at 86-87; Lataille/Jordan/Slattery Reply Decl. ¶¶ 54-55 & Exh. 29.

AT&T responds by pointing to the six CLECs that were EBITDA positive but that nonetheless entered into bankruptcy. But AT&T fails to show (or even claim) a nexus between these CLECs and the use of special access. And, in any event, five of these six carriers have emerged from bankruptcy, and the four that publicly report their financial results all have recently reported that they are EBITDA positive.⁴⁰ AT&T also claims that itself, MCI, and Sprint are struggling, but again fails to tie this in any way to the use of special access.⁴¹ Indeed, much of this is due to *increased* competition these companies face in their core long distance services,⁴² and to charges these companies have been forced to take to write down the value of their long-distance assets.⁴³

⁴⁰ See, e.g., XO Press Release, *XO Communications Reports Improved Third Quarter 2004* (Nov. 9, 2004) (XO's "financial performance in the third quarter of 2004 continued to meet our expectations, highlighted by the achievement of positive EBITDA.") (quoting CEO Carl Grivner); ITC^DeltaCom Press Release, *ITC^DeltaCom Reports Third Quarter 2004 Financial Results* (Nov. 11, 2004) (ITC^DeltaCom "[r]eported total operating revenues of \$145.4 million, which represented an increase of \$37.3 million, or 34.5%, over the third quarter of 2003."); McLeodUSA Press Release, *McLeodUSA Reports Third Quarter 2004 Results* (Nov. 9, 2004) ("Adjusted EBITDA for the period was \$11.5 million, resulting in the tenth consecutive quarter of positive Adjusted EBITDA."); Knology Press Release, *Knology Reports Third Quarter Results* (Oct. 27, 2004) ("Knology reported EBITDA, as adjusted . . . of \$6.3 million for the third quarter of 2004.").

⁴¹ See AT&T White Paper at 11; AT&T Reply at 73-75.

⁴² See, e.g., AT&T News Release, *AT&T Announces Third-Quarter 2004 Earnings* (Oct. 21, 2004) ("Long-distance voice revenue decreased 16.3 percent from the prior-year third quarter, driven by continued pricing pressure in both the retail and wholesale businesses, as well as a continued decline in retail volumes."); Sprint Press Release, *Sprint Reports Third Quarter 2004 Results* (Oct. 19, 2004) (reporting that in the long distance segment "overall revenues continued to be impacted by the effects of lower market pricing, product substitution and competitive conditions.").

⁴³ See Sprint Press Release, *Sprint Reports Third Quarter 2004 Results* (Oct. 19, 2004) ("Consolidated Operating loss for the third quarter was \$2.7 billion reflecting the \$3.5 billion pre-tax, non-cash Long Distance asset impairment charge."); AT&T News Release, *AT&T Announces Third-Quarter 2004 Earnings* (Oct. 21, 2004) ("AT&T today reported a net loss of \$7.1 billion, or \$8.95 per diluted share, for the third quarter of 2004 . . . The third-quarter consolidated operating loss was \$11.3 billion, including asset impairment charges of \$11.4 billion and net restructuring and other charges of \$1.1 billion primarily related to employee separations. Excluding these charges, adjusted operating income was \$1.2 billion, yielding a margin of 15.6 percent."); MCI Press Release, *MCI Announces Third Quarter 2004 Results* (Nov. 4, 2004) ("Third quarter results include previously announced non-cash, pre-tax impairment charges of \$3.5 billion that reduced the carrying value of intangible assets and property, plant and equipment. . . . Excluding the impairment charges, the Company would have realized operating income of \$121 million.").

ATTACHMENT 1

**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

**EX-PARTE DECLARATION OF WILLIAM E. TAYLOR
ON BEHALF OF VERIZON**

SUMMARY

In previous declarations, I examined claims that special access pricing flexibility led to massive price increases and found that Verizon's special access average revenue per line fell sharply over the 1996-2003 period and fell even more dramatically during the pricing flexibility period from 2001 to 2003. This Declaration responds to various criticisms by AT&T regarding the data and calculations supporting these conclusions. In fact, these criticisms are incorrect. Dr. Selwyn, on behalf of AT&T, has identified no errors of data, arithmetic or interpretation in my previous work, and my original conclusion holds: that — in contrast to AT&T's shrill claims of price increases — special access prices have fallen rapidly and fallen more rapidly since pricing flexibility was introduced.

In this *Ex Parte* Declaration, I identify the differences between my calculations and those of Dr. Selwyn. Using either my data or those of Dr. Selwyn, when DSL revenues are removed from the ARMIS special access revenues and when the 2003 data

point is adjusted to remove *intrastate* special access revenues to provide a common basis for comparison¹, my conclusions remain the same:

- average revenue per VGE has fallen sharply over the 1996-2003 period, and
- that reduction has increased during the pricing flexibility period.

Specifically, for the former Bell Atlantic companies of Verizon, average revenue per VGE fell, in *nominal* terms, at an annual rate of 12.0 percent during the 1996-2003 period and 18.5 percent during 2001-2003, and fell, in *real* terms, at an annual rate of 14.0 percent during the 1996-2003 period and 20.1 percent during 2001-2003. For all Verizon companies (including GTE) — the sample of companies that Dr. Selwyn used in his analysis—average revenue per VGE fell, in *nominal* terms, at an annual rate of 12.0 percent during the 1996-2003 period and 17.5 percent during 2001-2003, and in *real* terms, by 13.9% for the 1996-2003 period and 19.1% for the pricing flexibility period.

While the shift in demand from low bandwidth to high bandwidth services can explain some of this reduction in average revenue per VGE, it does not explain the majority of the reduction, even when detailed demand shifts among all bandwidths are examined.

In conclusion, these arguments of detail must not obscure the main point. There is no disagreement that average special access revenue per VGE has fallen over the 1996-2003 period, and, more importantly, has decreased even more rapidly over the 2001-2003 period. This reduction in average revenue per VGE is utterly inconsistent with AT&T's allegations of price increases for special access services in pricing flexibility MSAs.

As for the details:

- *This price reduction accelerated after 2000.* Average annual price reductions are greater in the 2001-2003 period than in the 1996-2000 period using either my data or Dr. Selwyn's, provided one removes the artificial inflating effects of DSL revenue from ARMIS special access revenue and the inclusion of intrastate special access revenues in 2003 to obtain a common basis for comparison.

¹ Beginning in 2003, ARMIS Report 43-03 row 5083—which is the source that both Dr. Selwyn and I utilize for special access revenues—included both interstate and intrastate special access revenues. In our analysis we are interested in how *interstate* special access prices have fared since Verizon received interstate price flexibility in some of its MSAs. In order to accomplish this, we use ARMIS Report 43-04 row 4012 column d, which reports interstate special access revenue only.

- *This price reduction is not explained by the observed shift in demand towards higher-bandwidth special access services.* As I already explained in my Reply Declaration, the price of DS-1 service by itself fell by an average of 6.5% per year (in real terms). Possible demand shifts to higher bandwidth services have no effect when the price of a single service is examined in isolation. Moreover, even using Dr. Selwyn's (hypothetical) price data and Verizon's actual demand shares in 2002 and 2004, I show that if nominal prices were unchanged over the period, average revenue per VGE would have fallen by about 6.9 percent due to demand shifts, far short of the 18.5 percent reduction in average revenue per VGE.
- *This price reduction is not explained by the fact that many MSAs remain under price cap regulation.* In fact, the price cap index fell much slower than average revenue per VGE in both the pre and post pricing flexibility periods.

Finally, AT&T's suggestion that Verizon has engaged in a price squeeze, facilitated by pricing special access services above cost, makes no economic sense. Forgone contribution from special access is an opportunity cost Verizon incurs when it provides retail high capacity services; whether that contribution is high or low has no effect on retail competition. Moreover, because (i) ILECs cannot drive competitors and their associated facilities from the market and (ii) barriers to entry are low, there is no prospect for recouping the profits that would be lost in a price squeeze. In particular, ILECs cannot recoup lost profits by overallocating common costs to price-capped services and raising prices because cost allocations have no impact on the regulated prices of those services.

**Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554**

In the Matter of

Unbundled Access to Network Elements

Review of the Section 251 Unbundling
Obligations of Incumbent Local Exchange
Carriers

WC Docket No. 04-313

CC Docket No. 01-338

I. Introduction and Background

1. 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 and a reply declaration on October 19, 2004.²

2. I have been asked by Verizon to respond to certain allegations made by AT&T regarding my analysis of special access service prices.³ In particular, Dr. Selwyn on behalf of AT&T claims that my results: (1) rely upon data and data sources that have been neither cited nor disclosed, (2) are not reproducible using the data sources that have been cited, and (3) contain several important mathematical or data input errors whose effect is to produce apparent relationships that run counter to reality. In addition, he accuses me of concealing and distorting evidence of demand shifts by aggregating multiple distinct services into the same “category,” and attempting to downplay the relative importance of each of these factors through a succession of erroneous and

² Declaration and Reply 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 and October 19, 2004.

³ See Ex Parte Declaration of Lee L. Selwyn on behalf of AT&T Corp, November 8, 2004, (“Selwyn Ex Parte”).

irreproducible calculations. Dr. Selwyn is mistaken on each point and in this Ex Parte, I provide a rebuttal of his flawed analyses.

3. In my initial declaration, I concluded that average revenue per special access line has fallen over time, and that the drop has accelerated since the ILECs received special access pricing flexibility in some MSAs. In my reply declaration, I removed DSL revenue from the calculation, because DSL lines were not included in the special access line count. Hence, including DSL revenue would artificially inflate average revenue per VGE, and, since DSL revenue grew rapidly in the 2001-2003 period, including the DSL revenue would also inflate the growth in average revenue per VGE. I also concluded that the impact of demand shifts to higher bandwidth services on the drop in average revenue per VGE is likely to be small, so that average revenue per VGE fell in large part because of price reductions (including discounts and contracts) and not entirely because demand shifted from low bandwidth to high bandwidth services.

II. DSL Revenues

4. Dr. Selwyn raises two issues: (1) the DSL revenue data are not broken out separately in the ARMIS 43-04 Report I cited and (2) not all DSL-related revenue was included in the interstate special access category in the ARMIS reports, and therefore it is possible I removed too much DSL revenue. First, Verizon provided the DSL revenue data I used in my analysis, and a copy of those confidential data are attached to this *ex parte* report. These DSL revenue data are, in fact, the same data that Verizon includes as a part of special access revenue in ARMIS Report 43-04, (as cited in my reply declaration), and nothing more. DSL data are not required to be reported separately and are confidential. Dr. Selwyn is thus incorrect in his speculation that I may have removed DSL revenue that Verizon did not include in the ARMIS special access revenue reports.

5. There are, however, two corrections to my calculation that I need to make, the results of which do not change my conclusions. First, as I discuss below, I based my calculation for Verizon on all the companies that were owned by Bell Atlantic, NYNEX or Verizon throughout the 1996-2003 period, *i.e.*, excluding the former GTE and Contel companies from the analysis. My DSL adjustment, however, incorrectly included DSL revenue from all Verizon companies, including former GTE and Contel operations. Second, the

data source that I used for special access revenue is ARMIS 43-03 row 5083, which contains *interstate* special access revenues. Intrastate special access revenues are reported in row 5084. Beginning in 2003, however, ARMIS 43-03 row 5083 contains both interstate and intrastate special access revenues. Therefore I must adjust the row 5083 special access revenue for 2003 to remove the intrastate amount in order to obtain a consistent basis for comparison. When I make these two corrections, the average revenue per VGE falls, in *nominal* terms, by 18.5% per year during the pricing flexibility period, not the 20.7% shown in my reply declaration, and in *real* terms, by 20.1 percent during the pricing flexibility period. Table 1 below presents my results with the corrected DSL adjustment and the removal of intrastate special access revenue in 2003.⁴

TABLE 1			
VERIZON SPECIAL ACCESS REVENUE PER VGE			
(UPDATED DSL AND REMOVAL OF 2003 INTRASTATE REVENUE)			
		Nominal Annual Growth	Real Annual Growth
All Data 1996 – 2003	Previous ⁵	-12.7%	-14.6%
	Update	-12.0%	-14.0%
Before Pricing Flexibility 1996-2000	Previous ⁵	-11.8%	-13.8%
	Update	-11.4%	-13.5%
During Pricing Flexibility 2001-2003	Previous ⁵	-20.7%	-22.2%
	Update	-18.5%	-20.1%

6. Dr. Selwyn’s data also suffers from this inconsistency: *i.e.*, his 2003 special access revenues also include both interstate and intrastate revenues. When I use his set of Verizon companies and remove 2003 intrastate special access revenues from his data to obtain a consistent basis of comparison, the results change significantly. See Table 2 below.

⁴ As corrected, Special Access Revenue includes only interstate revenue throughout the period. Special access lines from ARMIS include both interstate and intrastate lines throughout the period and cannot be separately identified. The annual change in interstate Special Access Revenue per Special Access VGE should not be affected by the inclusion of intrastate special access lines in the denominator in every period.

⁵ Taylor Reply Declaration Table 1.

TABLE 2				
Nominal Growth Calculations, Including GTE/Contel Companies				
	Selwyn Data Original		Selwyn Data ADJUSTED TO REMOVE 2003 INTRASTATE SPECIAL ACCESS	
	INDEX	GROWTH	INDEX	GROWTH
1996	100.0		100.0	
1997	93.8	-6.2%	93.8	-6.2%
1998	88.3	-5.9%	88.3	-5.9%
1999	81.4	-7.8%	81.4	-7.8%
2000	62.4	-23.3%	62.4	-23.3%
2001	60.3	-3.5%	60.3	-3.5%
2002	62.7	4.1%	62.7	4.1%
2003	52.8	-15.8%	48.2	-23.2%
	Average Annual Growth		Average Annual Growth	
1996-2003	-8.7%		-9.9%	
1996-2000	-11.1%		-11.1%	
2001-2003	-6.4%		-10.6%	

Dr. Selwyn calculates average annual growth as the arithmetic average of the year-over-year changes, while I use geometric growth.⁶ However, this difference is not numerically important. If we use his arithmetic growth, we see the same pattern as shown in Table 2.⁷ When, in addition, the DSL revenues are removed from his data, Table 3 shows that his conclusions reverse.

⁶ Geometric growth includes compounding. If you start at 100.0 and apply 7 years of compound growth at Dr. Selwyn's average growth rate, you get 54.3, not the 52.8 in Dr. Selwyn's data in the first column of the above Table. If you use geometric growth, you get precisely 52.8.

⁷ Correcting his 2003 data to remove intrastate revenue causes special access revenues per VGE to fall at 9.6% per year during the 2001-2003 period, rather than the 5.9% that he reported (and the 10.6% we calculate using geometric growth in Table 2).

TABLE 3				
Nominal Growth Calculations, Including GTE/Contel Companies				
	SELWYN DATA		SELWYN DATA	
	ORIGINAL		ADJUSTED TO REMOVE 2003 INTRASTATE SPECIAL ACCESS & DSL DATA	
	INDEX	GROWTH	INDEX	GROWTH
1996	100.0		100.0	
1997	93.8	-6.2%	93.8	-6.2%
1998	88.3	-5.9%	86.7	-7.6%
1999	81.4	-7.8%	79.4	-8.4%
2000	62.4	-23.3%	60.3	-24.0%
2001	60.3	-3.5%	60.3	0.0%
2002	62.7	4.1%	57.6	-4.4%
2003	52.8	-15.8%	41.0	-28.9%
	Average Annual Growth		Average Annual Growth	
1996-2003	-8.7%		-12.0%	
1996-2000	-11.1%		-11.9%	
2001-2003	-6.4%		-17.5%	

Using Dr. Selwyn’s sample of companies, removing the DSL revenue and removing intrastate 2003 special access revenue results in an average annual reduction of 17.5% in average revenue per VGE for the 2001-2003 period. In addition, the annual decline in average revenue per VGE accelerates sharply during the pricing flexibility period, irrespective of how the growth rate is calculated.

7. Similarly, the sample of companies used makes no important difference. Table 1 adjusts the Bell Atlantic companies’ data to remove DSL revenue and 2003 intrastate revenue, and the results are similar to those for all Verizon operating companies in Table 3: for comparison, Table 1 shows annual nominal growth rates of –12.0% for the entire 1996-2003 period, -11.4% for the period before pricing flexibility and –18.5% during the pricing flexibility period.

III. Dr. Selwyn incorrectly claims that my analysis relies upon unsourced and erroneous calculations

8. Dr. Selwyn claims (¶9) that I present “a series of entirely undocumented calculations,” and that the ARMIS data that I cited show “*precisely the opposite* – a greater rate of decrease in average revenue per VGE under price caps than under pricing flexibility.” For example, he states that when these alleged deficiencies are corrected, instead of average revenue per VGE decreasing by 11.7% per year, he asserts that they decrease by 5.9% per year.⁸

9. First, I did properly cite the source for the data I relied upon in my analysis. In my initial declaration (¶5) I stated:

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 **Report ARMIS 4308, 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. [Emphasis Added]

10. The difference between my analysis and Dr. Selwyn’s is simply the set of companies used. Because I was updating my 2002 study with Professor Kahn, I used the same companies we used then, namely all the (former) Bell Operating Companies that at one time comprised NYNEX and Bell Atlantic. In contrast, Dr. Selwyn included the GTE and Contel companies throughout the 1996-2003 period, including times when they were not owned by Verizon. As discussed above, however, the 2003 revenue increase claimed by Dr. Selwyn is only an artifact of a change in ARMIS reporting requirements: *i.e.*, including intrastate special access revenue in Row 5083 of ARMIS Report 43-03. A comparison of Table 1 and Table 3 above shows that when this change is accounted for and the DSL revenue is removed from either my (RBOC-Verizon) data or Dr. Selwyn’s (RBOC-Verizon plus GTE and Contel) data, the results are reasonably close. When DSL revenues and intrastate special access revenues are removed from ARMIS special access

⁸ Selwyn Ex Parte, Tables 1 and 2.

revenues, average revenue per VGE declined over the 1996-2003 period and declined faster in the 2001-2003 period. I attach the data used in my analysis in Exhibit I.

11. Dr. Selwyn also claims that the price reductions that are suggested by the average revenue per VGE reductions during the price flexibility period can be attributed to the mandatory price cap reductions applicable in the MSAs not subject to Phase II pricing flexibility. This explanation is incorrect. Under price cap regulation, the price cap index declines at the rate of inflation minus the X-factor, but regulated firms can lower special access prices more rapidly than that if market conditions warrant. Table 4 shows that during the 2001-2003 period, the price cap index fell (on average) at 4.88 percent per year, which amounts to about a quarter of the overall 18.5% annual reduction in special access average revenue per VGE during that period.

Table 4 Price Cap Index Reductions			
Year	GDPPI	X-factor	Index = Index(-1) * (1 + GDP-PI - X-factor)
2000			1.00
2001	2.37%	6.50%	0.96
2002	1.87%	6.50%	0.91
2003	1.37%	6.50%	0.87
2001-2003 annual geometric growth = $[\text{Index}(2003) / \text{Index}(2001)]^{(1/2)} - 1$			-4.88%

Source: Verizon for actual GDPPI used in the price cap filings.

12. Clearly, competitive conditions in the special access markets have caused prices to fall far faster than the 4.88 percent per year required by the price cap formula. In MSAs where Verizon has Phase I or II pricing flexibility, Verizon has the ability to offer contract pricing in response to competition, which causes average revenue per line to fall even where base-rate tariffed prices do not.

IV. Shifting demand towards higher bandwidth services does not account for a large share of the observed 18.5% reduction in average revenue per VGE

13. In my reply declaration, I demonstrated that the large reduction in average revenue per VGE is not principally driven by the shift in demand from lower to higher bandwidth services, as Dr. Selwyn incorrectly asserts. Specifically, I demonstrated in a simple, aggregate example that the shift in demand could account for at most 5.9 percentage points of the observed 20.7 percent decrease in nominal average revenue per VGE prior to the corrections described above.

14. Dr. Selwyn asserts (at ¶16) that,

Dr. Taylor’s calculation is *critically dependent* upon one *entirely unsupported and almost certainly false assumption*—namely, that no demand shifts toward higher capacity special access services have taken place *within* each of these two service categories—that is, the relative mix of DS0 and DS1 services, and the relative mix of DS3 and OCn services, each remained *unchanged* from January 2002 through September 2004.

He then provides a hypothetical example that “relaxes” my assumption and purports to show that “when *intra-category* demand shifts are included in the analysis, the effect of such demand shifts can *by itself* reduce the average revenue per VGE by more than Dr. Taylor’s 5.9% maximum.”

15. As a matter of arithmetic, it is obvious that one can construct hypothetical intra-category demand shifts that change the aggregate results. Dr. Selwyn’s example distributes the DSO-DS1 mix and the DS3-OCn mix into the separate services in a way that changes slightly my numerical result but which reaches the same economic and policy conclusion: that the rapid annual reductions in average revenue per VGE were due to something more than a shift in demand towards higher-bandwidth services.

16. In the Table below, I use Verizon’s *actual* percentage mix of the different service types and maintain Dr. Selwyn’s (hypothetical) price ratios. As Table 5 shows, the maximum annual reduction in average revenue per VGE that could be attributed to demand shifts is 6.29%, out of a total reduction, in nominal terms, of 18.5%. In other words, the demand shifts that Dr. Selwyn asserts are the principal reason why average revenue per VGE falls, in actuality explain only approximately 35 percent of the

hypothetical reduction, with the remaining 65 percent attributable to price declines. *See* Exhibit 2.

17. This evidence provides no support for Dr. Selwyn's speculation that demand shifts could reconcile the reduction in average revenue per VGE with his asserted price increases in like-for-like services over the 2001-2003 period. Moreover, whether demand shifts account for a large or small fraction of the reduction in average revenue per VGE, the fact remains that average revenue per VGE *fell*: fell more rapidly under pricing flexibility and fell by more than what can be explained by a shift in demand towards higher bandwidth services. These data contradict Dr. Selwyn's claim of rampant price *increases* taking place under pricing flexibility.

V. Dr. Selwyn is incorrect when he asserts that my baseline figures fail to add up and that there is a mathematical impossibility

18. Dr. Selwyn asserts (¶5, Appendix 1) that, "from a simple arithmetic standpoint, Dr. Taylor's Table 1 baseline figures fail to add up...[s]ince the two separate 1996-2000 and 2001-2003 figures are presumably the only components of the 1996-2003 figure, an average taken across all data that is smaller than the average for each of its component parts is a mathematical impossibility, unless, of course, the two component periods presented by Dr. Taylor intentionally *do not* constitute the entire 1996-2003."

19. The growth rates in question are annual growth rates for the periods 1996-2003, and the non-overlapping 1996-2000 and 2001-2003 sub-periods. The sub-periods do not overlap because pricing flexibility was only authorized in a small number of MSAs at the end of 2000 and was introduced during 2001. Thus, the period 1996-2000 is virtually free of effects of special access pricing flexibility, and the period 2001-2003 is indicative of behavior under pricing flexibility. It is not necessarily the case that the growth rate for 1996-2003 is an average of the growth rates for 1996-2000 and 2001-2003.

VI. Price Squeeze Allegations are Flawed

20. AT&T's claim that ILECs can engage in a price squeeze involving high capacity facilities is without merit, as is its claim that setting special access rates above costs facilitates such behavior. A price squeeze cannot occur unless the firm attempting the

price squeeze controls an upstream essential facility.⁹ Special access services and the underlying infrastructure used to provision those services are not essential facilities. Point-to-point high capacity services are provided in a robust competitive market, and many competitors economically deploy their own infrastructure to provide high capacity service.

21. Moreover, even if high capacity facilities were an essential service (which they are not), the margin (price minus incremental cost) by which special access services are priced above cost plays no role in determining whether Verizon can perpetrate a price squeeze. In claiming the contrary, AT&T overlooks the very real opportunity costs that Verizon incurs when it carries retail high capacity traffic and foregoes selling special access services to its retail competitors. To maximize corporate profits, Verizon must recognize the lost special access revenues as an *opportunity cost* of having its retail high capacity service carry the traffic instead of supplying special access service to a competitor. If Verizon's retail high capacity services cannot earn enough revenue to cover both its own costs and the opportunity cost of special access, then taking the traffic away from the competitor would be unprofitable for the corporation as a whole regardless of the cost of the underlying service.

22. In addition, Verizon would have no economic incentive to engage in predatory pricing by a price squeeze or any other means. A price squeeze entails a sacrifice of current profits, and sacrificing current profits with the intention of driving competitors out of the market is not a likely recipe for profit under the best circumstances. In a predation strategy, the losses or reduced profits are certain and occur immediately while recouping the losses is uncertain and occurs in the future. Given that a dollar today is worth more in the future, in order to recoup the equivalent of dollar loss today the firm would have to make up in monopoly profits far more than a dollar in the future. Thus, even if the firm could drive competitors from the market and even if barriers to entering the market were prohibitively high (assumptions which are not the case in

⁹ An essential facility is a monopoly input that competitors must purchase that cannot be economically duplicated. See, for example, Jerry A. Hausman and Timothy J. Tardiff, "Efficient Local Exchange Competition," *Antitrust Bulletin*, Fall 1995, pp. 529-556.

telecommunications markets), a predatory strategy is extremely risky. In the words of the Supreme Court:

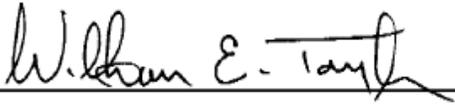
the success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain...For this reason, there is a consensus among commentators that predatory pricing schemes are rarely tried and even more rarely successful.¹⁰

Moreover, once placed, network facilities are sunk, and even if their owners could be driven from the market, the facilities cannot. There is thus little hope of eventual recoupment of profits lost through a price squeeze, so we do not expect to find ILECs pursuing such strategies. A far more likely explanation for AT&T's concern is the fact that all competitors prefer to compete against higher prices, and petitioning the regulatory authority for a price umbrella may be a more profitable strategy than competing in the marketplace.

¹⁰ *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

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

Executed on December 1, 2004



Dr. William E. Taylor
NERA

EXHIBIT 1

REDACTED – FOR PUBLIC INSPECTION

EXHIBIT I

VERIZON (Bell Atlantic/NYNEX only)			
Year	Special Access Revenue (\$000)	DSL Revenue (\$000) (Confidential VZ Data)	Special Access Lines
1996	\$960,097		3,213,729
1997	\$1,222,082		4,151,013
1998	\$1,471,142		5,463,756
1999	\$1,935,290		7,638,419
2000	\$2,523,353		13,267,652
2001	\$3,212,221		17,439,560
2002	\$3,712,410		18,541,231
2003	\$3,674,434		26,072,692
VERIZON (Including GTE/Contel)			
Year	Special Access Revenue (\$000)	DSL Revenue (\$000) (Confidential VZ Data)	Special Access Lines
1996	\$1,318,977		4,534,619
1997	\$1,624,225		5,952,898
1998	\$2,026,086		7,890,191
1999	\$2,708,561		11,445,395
2000	\$3,497,939		19,261,037
2001	\$4,368,442		24,921,686
2002	\$4,889,620		26,803,797
2003	\$4,861,314		34,703,115

Source: Special access lines, ARMIS 43-08 row 910 columns (fj*fk); special access revenues 1996-2002 ARMIS 43-03 row 5083 column (i), for 2003 ARMIS 43-04 row 4012 column (d); DSL revenues from Verizon.

EXHIBIT 2

REDACTED – FOR PUBLIC INSPECTION

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ATTACHMENT 2

REDACTED – FOR PUBLIC INSPECTION

REDACTED – FOR PUBLIC INSPECTION

ATTACHMENT 3

REDACTED – FOR PUBLIC INSPECTION

REDACTED – FOR PUBLIC INSPECTION