STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 05-C-0237 - Joint Petition of Verizon New York Inc. and MCI, Inc. for a Declaratory Ruling Disclaiming Jurisdiction over or in the Alternative for Approval of Agreement and Plan of Merger.

CASE 05-C-0242 - Joint Petition of SBC Communications Inc., AT&T Corporation, together with its Certificated New York Subsidiaries, for Approval of Merger.

DEPARTMENT OF PUBLIC SERVICE STAFF

WHITE PAPER

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I. Introduction

On February 25, 2005, Verizon Communications Inc. (Verizon) and MCI, Inc. (MCI) filed a Joint Petition (Verizon/MCI Petition) with the New York Public Service Commission (the Commission) detailing Verizon's proposed acquisition of MCI pursuant to the Agreement and Plan of Merger (Agreement).[1] The Verizon/MCI Petition also requested a declaratory ruling that the Commission lacked jurisdiction to review the merger. On February 28, 2005, SBC Communications Inc. (SBC) and AT&T Corporation (AT&T) filed a Joint Petition (SBC/AT&T Petition) to merge pursuant to the provisions of a jointly executed January 30, 2005 Merger Agreement.[2]

On April 1, 2005, the Commission issued Notices Soliciting Comments[3] on issues raised by the mergers, including, but not limited to impacts in New York State on:

1) Competition for the high-end business market, mass market and other markets.
2) Service quality and consumer interests.
3) Infrastructure issues.
4) Financial and operational matters.
5) The interrelationships of the mergers.

Comments were received from 13 parties regarding the MCI/Verizon merger[4] and from five parties regarding the SBC/AT&T merger[5] on April 29, 2005; reply comments were received from both Petitioners on May 13, 2005.

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[1] Verizon and MCI subsequently amended and filed certain financial and other terms in their merger agreement dated March 29, 2005 and May 5, 2005.

[2] The SBC/AT&T petition did not challenge the Commission's jurisdiction. (see Section IV - Commission Jurisdiction).

[3] Case 05-C-0237, Joint Petition of Verizon New York Inc. and MCI, Inc. for a Declaratory Ruling Disclaiming Jurisdiction over or in the Alternative for Approval of Agreement and Plan of Merger and Case 05-C-0242, Joint Petition of SBC Communications Inc., AT&T Corporation, together with its Certified New York Subsidiaries, for Approval of Merger. A "Notice Soliciting Comments" regarding both proceedings was issued April 1, 2005.

[4] Regarding the VZ/MCI merger petition, comments were received from: the Office of the Attorney General of New York State (AG); the Committee on Corporations, Authorities and Commissions; Communications Workers of America (CWA); Broadview, Networks, Inc., Broadview NP Acquisition Corp., BridgeCom International, Inc., CTC Communications Corp., and XO Communications Services, Inc. (the Competitive Carrier Group or CCG); Consumer Commenters (Consumer Federation of America, Consumers Union and New York Public Interest Group); the Consumer Protection Board (CPB); Conversent Communications of New York, LLC (Conversent); Covad Communications Company (Covad); Level 3 Communications, LLC (Level 3); the Public Utility Law Project (PULP); New York Coalition of Rural Independent Carriers (Rural Independents); Qwest Communications Corporation (Quest) and US LEC Communications Inc. (US LEC).

[5] Regarding the SBC/AT&T merger petition, comments were received from: Covad, Level 3, Qwest, Rural Independents and US LEC.

This White Paper presents Staff's preliminary analyses and tentative conclusions about the impact of both mergers on New York consumers. Staff's conclusions are primarily based on information available to us, including information provided by Petitioners in response to Staff inquiries. In some instances information has not yet been provided to Staff. Certain implications of the Verizon/MCI merger could not be analyzed because, unlike the situation in the Bell Atlantic/NYNEX merger, where the companies engaged in post-transition planning through the creation of Joint Merger Teams, Verizon reports that it has not done any analysis regarding facilities, systems or organizations that may be abandoned, combined or retired, and has not begun post merger operational planning. Finally, issues associated with the Internet backbone[6] are excluded from Staff's review as such issues are more properly assessed at the national level.

II. Executive Summary

The proposed mergers are taking place at a critical juncture in the telecommunications market, not only in New York, but nationwide. These mergers represent the first vertical integrations of a Regional Bell Operating Company (RBOC) and a traditional long distance provider (which also provides local exchange services) at a time when telecommunications voice and data alternatives are being widely provided not only by the traditional wireline telephone companies, but also by the cable industry, broadband Voice Over Internet Protocol (VoIP) providers and wireless carriers. These changes in technology are providing consumers with a variety of choices from different service providers. Customer choice is essential, and the State of New York has more customer options available than almost any other State. The mergers are being examined with a view toward maintaining this important customer benefit.

At the outset, Staff concludes that the Commission has jurisdiction over the transactions and must review them. Staff's tentative conclusions and potential remedies are based upon a series of questions, some of which have not yet been addressed by the Petitioners, and include: 1) the discovery responses received to date; 2) the comments and other information submitted by the parties to the Federal Communications Commission (FCC); 3) information gathered by

[6] Internet backbones are high speed networks interconnecting many local and regional networks.

the Department in connection with the Triennial Review Order (TRO)[7] and Triennial Review Remand Order (TRRO);[8] and 4) other publicly available information, including the Horizontal Merger Guidelines of the U.S. Department of Justice and Federal Trade Commission.[9] Staff recognizes that the mergers impact not only New York State telecommunications markets, but national markets as well, and that certain market concerns/considerations may be more appropriately addressed at the federal level (by the FCC or the Department of Justice). However, this paper analyzes the impacts of these mergers on New York State telecommunications markets specifically, and the tentative conclusion and remedies that are put forth in this document are aimed at the impacts on New York's consumers.

Verizon/MCI Merger

We tentatively conclude that while the Verizon/MCI merger will impact the mass market (residential and small business), and while there is significant mass market intermodal competition providing voice and data alternatives in most parts of New York,[10] the Verizon/MCI merger will increase the concentration in that market. While MCI may have been moving out of the local circuit switching exchange market, there is no evidence of the company's intent to abandon the overall local telecommunications market. Instead, like AT&T, it could have pursued an Internet protocol (IP) delivery platform.

To offset what appears to be reduction in choice, there are potential remedies available, for example, requiring that Verizon offer "naked DSL" wherever it offers DSL services to its own customers. This would allow customers to use DSL to take advantage of the burgeoning Voice over the Internet Protocol (VoIP) market without also subscribing to Verizon's telephone service. Also, another potential remedy is for MCI to continue to offer its retail residential service for a year after the merger is approved.

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[7] In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, ("Triennial Review Order" or "TRO"), 18 FCC Rcd 16978 (2003).

[8] In the Matter of Review of the Section 251 Unbundling Obligations of Incumben Local Exchange Carriers. WC Docket No. 04-313, CC Docket No. 01-338, Order on Remand, FCC 04-290 (rel. February 4, 2005).

[9] Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission, (Issued April 2, 1992 and revised April 8, 1997).

[10] Comments of the New York Department of Public Service, <u>In the Matter of Unbundled Access to Network Elements, Review of 251 Unbundling Obligations of Incumbent Local Exchange Carriers</u>, WC Docket No. 04-313,CC Docket No. 01-338 (filed October 4, 2004).

With regard to service quality assurances for the residential market, we tentatively conclude that the Commission's recently announced initiative, the Comp III proceeding,[11] which will undertake a broad review of telephone regulation in New York, presents an appropriate forum to consider these issues. However, to ensure that Verizon continues to focus on maintaining good service quality in New York, especially in areas where adequate competition does not yet exist, a potential remedy might be that before Verizon is permitted to exercise any potential pricing flexibility in those areas in the future, it must show that it is maintaining good service quality performance according to the Commission standards.

With respect to the large business (enterprise) and medium size business markets, we tentatively conclude that the Verizon/MCI merger will produce significant consolidation and is, therefore, more troubling. There are, however, remedies available to the Commission that would adequately address the harmful effects of a highly concentrated wholesale market. For example, Staff tentatively concludes that remedies aimed at the upstream wholesale market should allow smaller competitive wholesale carriers to continue to provide their services to medium and large customers, thereby preserving customer choice. A potential remedy is that smaller carriers would be entitled to the same rates, terms and conditions for wholesale services that they currently receive from MCI, or which are currently tariffed or offered under Special Pricing Arrangements (SPAs), for a period of 36 months. We also ask whether Verizon/MCI should make available competitive wholesale rates, terms and conditions in commercial agreements with these carriers and extend the terms of expiring interconnection agreements to ensure that other competitors can effectively compete for retail customers. We also seek input on how these remedies should be implemented and enforced. These and other remedies (including the viability of divestiture) are described below.

Finally, we tentatively conclude there is no basis for instituting a rate proceeding in the current competitive environment. Verizon is facing, and, with appropriate remedies as discussed in this paper, will continue to face, major competition and therefore expecting that it pass on the synergy-related savings and revenue enhancements to customers is not necessary and will make it even more difficult for the company to compete. However, we tentatively conclude that it is reasonable to expect that New York customers will be insulated from the costs of the merger,

[11] Case 05-C-0616, Proceeding on Motion of the Commission to Examine Issues Related to the Transition to Intermodal Competition in the Provision of Telecommunications Services, Order Initiating Proceeding and Inviting Comments (issued June 29, 2005) (Comp III).

including any additional costs due to Verizon's use of GAAP purchasing accounting to record the merger. In addition, New York consumers should be protected in the event MCI accounting or other improprieties may come to light should the merger be approved. We also believe that the Commission's Competition III proceeding will be an effective and efficient forum to discuss how the Commission should treat Verizon's and other local exchange carriers' financial conditions and earnings in a competitive world.

SBC/AT&T Merger

In general, the SBC/AT&T merger does not raise the same level of concern as the Verizon/MCI merger in New York State. SBC and AT&T operate as competitive local exchange carriers (CLECs) in New York, and as such, both are subject to lightened regulation. SBC has a relatively small share of the New York market, and AT&T will remain a distinct and independent economic entity from the major ILEC in New York (Verizon-NY). Therefore, we tentatively conclude this merger will not have a major impact on New York's market. Instead, the major issue associated with the AT&T/SBC merger centers on the consolidation of the nationwide large business market.

While AT&T is a major supplier of telecommunications services in New York, SBC is not. Therefore, we tentatively conclude that a merger between the two does not remove a major supplier, AT&T, from the New York market because AT&T will still be present in the form of the merged company, after the merger. Were AT&T to have merged with another major supplier in New York, then our tentative conclusion may have been different. AT&T is merging with SBC, a small supplier in the New York markets. This merger, therefore, does not appear to yield a significant reduction in choices for New York customers.

Given the lack of significant harm to competition caused by the SBC/AT&T merger, Staff tentatively concludes that, unlike the Verizon/MCI merger, remedies are not needed. Moreover, Staff tentatively concludes that there is little cause for concern associated with service quality as both AT&T and SBC have recently received Commission commendations for service quality.

Finally, where there are synergies expected as a result of the SBC/AT&T merger, but we tentatively conclude that there is not a basis for the Commission to seek recovery of a portion the cost savings and additional revenues resulting from those synergies in the current competitive environment. While we acknowledge that the rating agencies have given indications that the business risks and challenges posed by integration of AT&T into SBC (and AT&T Wireless into Cingular) may result in SBC's credit rating falling, we tentatively conclude that the Commission need not address this issue because of our lightened regulation of such carriers. We also find no basis for applying to this merger our recommendation in the Verizon/MCI mergers that Verizon's New York customers be insulated from the costs of the merger because of the Commission's lightened regulation of such carriers. Staff tentatively concludes that there is no basis for recommending the Commission reject the proposed transaction or imposing remedies.

In sum, these mergers reflect the changing telecommunications market brought about by vigorous competition and new technology. The Commission has long established its preference for competitive markets, but has also recognized that during the transition appropriate oversight is necessary. Consequently, we seek comment on our tentative conclusions and remedies.

III. Verizon/MCI Merger - Background

Company Overviews

Verizon Communications provides telecommunications services in 29 states, Puerto Rico, the District of Columbia; and has over 53 million access lines nationwide. The company's 2004 operating revenues were $71 billion, and it has approximately 210,000 employees, of which about 35,000 (17%) are in New York State. Regulated telecommunication services in New York are provided by Verizon New York Inc. (VNY), which currently has about 9 million access lines in New York State, or approximately 20% of Verizon's lines nationwide.[12]

MCI, Inc. and its subsidiaries provide telecommunications services to residential, business and government customers throughout the United States. Telecommunications services in New York are provided by MCImetro Access Transmission Services LLC, MCI WORLDCOM Communications, Inc., MCI WORLDCOM Network Services, Inc., TTI National, Inc., Teleconnect Long Distance Services and Systems Company d/b/a Telecom USA, and Metropolitan Fiber Systems of New York, Inc. MCI's 2004 annual operating revenues were $21 billion (approximately 30% of Verizon's) and the company has approximately 42,500 employees with 1,380 (3%) of those in New York.

[12] FCC Report 43-08, the ARMIS Operating Data Report, Table III – Access Lines in Service by Customer.

Rationale for Merger

The Verizon/MCI merger petition states that the transaction is "in the public interest" and will have no "adverse effect on the rates or the quality of service of VNY, or the regulated MCI subsidiaries."[13] The primary rationale for the merger is that it will enhance Verizon's ability to provide a full array of telecommunications services.[14] The merger will "bring together two companies with complementary strengths"[15] and is "in keeping with an industry evolution that is trending toward convergence and consolidation."[16] Petitioners estimate the merger will generate significant revenues and cost savings for both entities.

Verizon characterizes its existing enterprise business as primarily regionally focused, and therefore, views the merger as an opportunity to expand its limited in-region, enterprise business market both nationally and internationally, areas where MCI has a strong presence.[17] It also plans to take advantage of MCI's national, international and Internet backbone networks.

MCI, on the other hand has a strong enterprise and Internet backbone product but its mass market business is experiencing revenue declines.[18] MCI suggests that it has no residential VoIP product, and views the merger as an opportunity to use Verizon's wireless product lines to offer a full suite of services to its enterprise customers.[19] Finally, MCI believes its merger with Verizon will provide a higher degree of stability and certainty for both companies.[20]

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[13] Case 05-C-0237, In the Matter of the Joint Petition of Verizon New York Inc. and MCI for a Declaratory Ruling, Disclaiming Jurisdiction over or in the Alterative for Approval of Agreement and Plan of Merger (issued, February 25, 2005), page 2.

[14] Verizon/MCI Petition, page 2.

[15] Verizon/MCI Petition, page 8.

[16] Verizon/MCI Petition, page 9.

[17] Over half of MCI's enterprise customers are located outside of Verizon's territory. Verizon estimates revenue enhancements as a result of the merger close to $1 billion. See February 14, 2005 Investor Conference Call Slides, pages 25 and 29.

[18] Over the past three-years, MCI's wireline revenues declined by 45% and mass market revenues shrank from $6.4 billion in 2003 to $5.1 billion in 2004 (Verizon and MCI Reply Comments to April 1, 2005 Notice Soliciting Comments in Case 05-C-0237 (Verizon//MCI Reply Comments), page 32.

[19] Verizon /MCI Petition, page 10.

[20] Verizon/MCI Petition, page 14.

IV. New York Public Service Commission Jurisdiction

In their Petition, Verizon and MCI present their agreement to merge as the acquisition of one Delaware holding company, MCI, Inc., by another, Verizon Communications, Inc. Because MCI, Inc. is not a Commission regulated utility, Verizon and MCI maintain that the transfer of only MCI's stock exempts this transaction from the review of franchise, asset, and stock transfers required by Public Service Law (PSL) Sections 99(2) and 100. In addition, Verizon and MCI cite Rochester Telephone Corporation, 18 NY PSC 271 (1978) (Rochester) in support of their contention that the Commission lacks jurisdiction over acquisitions of holding companies.[21]

Section 99(2) provides for jurisdiction over 1) transfers of telephone company franchises, 2) agreements affecting such telephone company franchises, and 3) transfers of the "works or system" of any telephone company. Characterizing the agreement to acquire MCI as involving only the acquisition of stock by one holding company from another echoes an argument made by Verizon, then Bell Atlantic Corp., in the Bell Atlantic/NYNEX merger that the Commission lacked jurisdiction to approve or disapprove the proposed merger between NYNEX and Bell Atlantic because NYNEX was a holding company without company franchises or assets and the merger involved only the acquisition of NYNEX stock. However, the Commission concluded that the Bell Atlantic/NYNEX merger required Section 99(2) approval because control of the franchises, assets, and stock of NYNEX's regulated subsidiary, New York Telephone Company (New York Telephone), would transfer to a new corporation, Bell Atlantic, after the merger. This transfer of control required Commission consent pursuant to Section 99(2) because "it affect[ed] the manner in which New York Telephone will exercise its rights to operate its system in New York State."[22]

The facts presented in the proposed Verizon/MCI merger parallel those in the NYNEX/Bell Atlantic merger. Both holding companies control regulated New York State subsidiaries. Control of the MCI subsidiaries' franchises and assets will pass from MCI to Verizon, a different corporation, as a result of the merger. Because this transfer of control will affect how the MCI subsidiaries operate as telephone corporations in New York State, §99 (2)

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[21] Rochester Telephone Corporation is now called Frontier Telephone of Rochester, Inc.

[22] Bell Atlantic/NYNEX Merger Order, page 13.

approval is required for the Verizon/MCI merger just as such approval was required in the Bell Atlantic/NYNEX merger. In addition, the provision of §99 (2) regarding agreements affecting a company's franchise or right to operate has consistently been interpreted as applying to any party to a contract affecting operation of a telephone company in New York State, irrespective of whether a party is telephone company.

Public Service Law Section 100

Section 100 of the Public Service Law requires Commission approval for telephone corporation acquisition of capital stock from another telephone corporation or the acquisition by any corporation of more than 10% of the voting stock of a telephone corporation. Verizon and MCI maintain that the proposed agreement to acquire MCI, Inc. stock does not come within Section 100 jurisdiction because MCI is not a jurisdictional telephone company.

A similar argument against Section 100 jurisdiction, based on the assertion that NYNEX was not a telephone corporation as defined by Section 2(17) of the Public Service Law, was raised in the Bell Atlantic/NYNEX merger. There the Commission concluded the after the merger, NYNEX control of New York Telephone stock would transfer to Bell Atlantic, and reorganization and absorption of NYNEX into Bell Atlantic triggered the need for Section 100 approval. [23]

Acquisition of MCI stock presents the same issue previously decided by the Commission in the Bell Atlantic/NYNEX merger. Just as NYNEX shareholders exchanged their stock for Bell Atlantic stock, "MCI's shareholders will receive ….shares of Verizon common stock….for every share owned of MCI."[24] As a result, MCI will be absorbed as a corporation. The proposed transaction, therefore, triggers the jurisdictional requirements of Section 100 of the Public Service Law as previously determined by the Commission in the Bell Atlantic (BA) merger with NYNEX (BA/NYNEX).

Rochester Telephone Corporation Case

Verizon and MCI cite a 1978 Commission decision in a proceeding involving Rochester Telephone Corporation,[25] as conceding lack of jurisdiction over holding companies. The

[23] Bell Atlantic control of NYNEX transferred via an exchange of NYNEX stock for Bell Atlantic stock.

[24] Verizon/MCI Petition, page 5.

[25] Case 27015, Rochester Telephone Corporation, 18 NY PSC 271 (1978).

Rochester proceeding presented the Commission with the issue as to whether Rochester Telephone Corporation should become an operating subsidiary of a holding company, Rotelcom, Inc. The Commission decided against the reorganization on public interest grounds, concluding that its legislative mandate required satisfaction of the public interest standard before Rochester Telephone acquired or developed new enterprises. The Commission denied the reorganization requested in Rochester Telephone because of the difficulty of ensuring that customers would not be harmed by improper affiliate transactions. The question of holding company jurisdiction or authority to review mergers or transfers of control was not decided in that proceeding. As the Commission made clear in the context of the Bell Atlantic/NYNEX merger, an agreement involving the ultimate restructuring of regulated subsidiaries invokes Public Service Law jurisdiction

Conclusion

Based on the foregoing, Staff concludes that jurisdiction to investigate and approve or deny the proposed acquisition of MCI by Verizon is vested in the Commission by the statutory authority conferred pursuant to Public Service Law Sections 99 and 100.

V. MARKET POWER

Staff's market power analysis focuses on the residential/small business, enterprise, transport and special access/high capacity loop markets to determine if the proposed merger will reduce the level of competition in those markets. Any anticompetitive impacts of the mergers must be balanced with a combination of remedies and/or benefits before the Commission can conclude that the mergers are in the public interest. If there is a finding that either of the mergers increases concentration in any of markets that have been analyzed, specific remedies, where possible, should offset the anticompetitive harm identified in the analyses.

Parties' Comments

Verizon/MCI maintain that the merger will not harm competition for any customers as a result of the technological convergence and intermodal competition which have transformed the telecommunications industry.[26] Verizon/MCI argue that their proposed merger “is a strategic

[26] Verizon/MCI Reply Comments, pages 3-4.

response to the convergence of voice, data, Internet, and video telecommunications services that has occurred nationally and in New York."[27] Verizon/MCI's Reply Comments discuss competitive alternatives which include: 1) cable companies; 2) wireless; 3) Internet communications and broadband services; 4) VoIP; and, 5) emerging technologies (Wi–Fi, Wi–Max, broadband over power lines and satellite broadband). Verizon/MCI contend that they have few overlapping assets, and that numerous competitors are also providing service in areas where those facilities overlap.[28] Certain parties propose the merger be conditioned on Verizon offering stand-alone or "naked" digital subscriber line (DSL) service. .

In contrast, the majority of the comments focus on an expected significant decrease in market competitiveness. The parties allege that these anticompetitive impacts will result from the increase in concentration in the "high-capacity local transmission market," specifically transport and special access services. Some comments also raise issues with increased concentration in the enterprise and mass markets. CCG, Qwest, US LEC, and Level 3 are among the competitors which oppose the merger transaction as currently structured. Other parties such as CPB, the Attorney General, Consumer Commenters, and PULP also indicate that the merger should not be approved as proposed.

More specifically, US LEC comments that "this transaction is unprecedented because it involves the dominant local exchange carrier absorbing, and thereby removing from the competitive marketplace, one of its largest competitors."[29] Conversent maintains that the Verizon/MCI merger, in combination with the SBC/AT&T merger, provides a strong incentive for tacit collusion to refrain for competing in each company's dominant region. US LEC expresses concern about the impact of the merger on the pricing, terms, and conditions of special access facilities.

Conversent comments that "the proposed merger can be expected to harm New York consumer welfare by significantly increasing the share of high-capacity local transmission inputs controlled by Verizon."[30] CPB also warns that the merger may reduce competition in the enterprise, high-capacity local services and mass markets. The Rural Independents raise market

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[27] Verizon/MCI Reply Comments, pages 4-27.

[28] Verizon/MCI Reply Comments page 29.

[29] US LEC Comments, page 7.

[30] Conversent Comments, page 2.

power concerns with respect to the "combined transport facilities and access services of Verizon and MCI" and "urges the Commission to recognize the threats imposed by large vertically integrated firms."[31] Conversent and CCG point out that the increase in concentration in local transmission facilities, including the special access and transport, results in strong incentives to raise rivals' costs.

Level 3 comments that "the merger as presently structured will have a significant negative impact on local exchange and intraLATA toll competition in the State of New York."[32] To help ensure that the merger is in the public interest, the Attorney General and CPB recommend that stand-alone DSL be provided for non-discriminatory access to the Internet backbone post-merger.

Consumer Commenters state that the proposed merger "will have profoundly anticompetitive effects across the full range of product and geographic markets taken by the merged parties."[33]

Qwest maintains that "the proposed transaction would eliminate all of the competition MCI provides to consumers and businesses in the retail market in Verizon's local exchange territory, as well as the important competition MCI provides as a source of wholesale services used by other competitors in New York."[34] The Competitive Carrier Group (CCG) requests a full investigatory proceeding given the lack of factual supportive data provided by the Petitioners.[35]

Finally, with respect to the SBC/AT&T proposed merger, SBC and AT&T argue that merger will not harm competition. Furthermore, SBC and AT&T contend that “there is not tacit agreement between SBC and Verizon not to compete with one another.”[36] Petitioners contend that their “competition for mass market customers can only increase from current levels.”[37]

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[31] Rural Independents Comments, page 6.

[32] Level 3 Comments, page 1.

[33] Consumers Commenters, page 1.

[34] Qwest Communications Corporation, Case 05-C-0237, page 1.

[35] Broadview Networks, Inc., Broadview NP Acquisitions Corp., Bridgecom International, Inc., CTC Communications Corp., and XO Communications Services, Inc make up the CCG.

[36] SBC/AT&T Reply Comments, page 11.

[37] SBC/AT&T Reply Comments, page 8.

The major competitive concern of the parties submitting comments to the SBC/AT&T merger is the competitive impact of tacit collusion (i.e., the merged SBC/AT&T not competing in New York with the combined Verizon/MCI).

Market Power Review Methodology

Market power should be examined in relation to the Commission's view of local exchange competition. In May 1996, the Commission articulated its overarching principles for developing a viable regulatory framework in a transitional environment and stated:

> *The goal of ensuring the provision of quality telecommunications services at reasonable rates is primary...Where feasible competition is the most efficient way by which the primary goal may be achieved.* [38]

The central question in the instant situation is whether a decrease in the number of competitors resulting from the merger raises anti-competitive concerns. The Petitioners in both mergers argue that the effects on competition associated with their respective mergers will be negligible.[39] However, Staff's analysis of the residential/small business, enterprise, transport and special access/high capacity loop market shares associated with the proposed merger raises significant concerns regarding market concentration in each of the segments that were analyzed.

Staff' identified areas of possible anti-competitive concern typically following the methodology set out in the Department of Justice (DOJ)/ Federal Trade Commission (FTC) Horizontal Merger Guidelines.[40] Those guidelines stem from the premise that as the number of competitors in a market declines, the potential for anti-competitive behavior increases. Staff used data collected from various sources[41] as a starting point to calculate market shares and Herfindahl-Hirschman Indices (HHIs) relevant to the proposed mergers. The HHI, endorsed by the DOJ, measures market concentration and recognizes the correlation between market concentration and the lack of market competitiveness. Concentration in a market is important because the level of concentration affects the behavior of firms in the marketplace. Greater market concentration is generally associated with behavior in which firms exercising market power seek to push prices above competitive levels.

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[38] Case 94-C-0095, Opinion and Order Adopting Regulatory Framework, Opinion No. 96-13 (issued May 22, 1996), page 3.

[39] See Verizon/MCI Petition pages 17 and 18 and SBC/AT&T Petition page 11.

[40] Department of Justice Horizontal Merger Guidelines, http://www.usdoj.gov/atr/public/guidelines/hmg.pdf.

[41] IRs, PAP/C2C, FCC Form 477.

The HHI for a market is calculated by summing the squares of the each individual company's market share. For instance, the HHI for a monopoly market would be 10,000 (100^2 = 10,000). Under DOJ guidelines, if the HHI for a market is greater than 1800 and if the proposed merger increases the HHI by more than 100, the rebutable presumption would be an increase in market power associated with the merger. However, this presumption could be overcome by an investigation of the factors affecting the competitiveness of the market, and the possible imposition of remedies to overcome the effects of market concentration. The Department of Justice Merger Guidelines interpretation of HHI scores are summarized in the table below.

Table 1 - Department of Justice Merger Guidelines on HHI

HHI Range	Market Type	Action
HHI = 1,000 or less	Market Not Concentrated	Not likely to be challenged
HHI = 1,000 to 1,800	Moderately Concentrated	Investigate if change in HHI > 100
HHI > 1,800	Highly Concentrated	Investigate if change in HHI > 50 Presume increase in market power if change in HHI>100

An HHI review is not the sole criterion that should be examined in a merger review. Entry barriers and current trends in the market should also be examined to determine if those factors mitigate the anti-competitive harms of the merger. The most important aspect in merger analysis is whether the proposed transaction will give the merged company market power that can be used to charge prices above competitive levels. In the telecommunications industry, market power could also be used to slow dynamic efficiencies (i.e., technological change) that are driving down prices. It would be unreasonable to allow additional market power that accrues from post-merger market concentration to remain unchecked. The anti-competitive harms associated with this concentration will be addressed by remedies that are described in the following sections.

The Staff approach to analyzing market competitiveness used here differs markedly from the FCC's impairment related competitive analysis discussed in the Department's October 4, 2004 comments to the FCC in the TRO Remand Proceeding (WC 04-313), in that Staff has relied upon DOJ/FTC merger guidelines. The recent FCC impairment methodologies [42] are

[42] TRO (FCC Triennial Review Order) and TRRO (FCC Triennial Review Remand Order).

used to identify *sufficient* competition. By contrast, the DOJ/FTC methodology focuses on market changes that lead to a *lack of* effective competition, and Staff has reached the conclusion that the potential for short run market power concentration can best be identified and assessed via the DOJ/FTC merger guidelines because Staff believes that the DOJ/FTC methodology is best suited to addressing the immediate anti-competitive impacts which the merger may engender.

Staff is continuing its analysis of how the two competition evaluation methodologies differ. Staff would like parties to comment on the following situation. How would the DOJ Guidelines and the FCC's TRO/TRRO impairment standards differ in their evaluation of the competitiveness of a transport route where the only current transport providers are Verizon, MCI and AT&T.

The analyses which follow include calculations of HHIs for the markets in question, and then compare those calculated HHI levels to the thresholds in the DOJ Horizontal Merger Guidelines.

Matching Remedies to Anti-competitive Harms

Staff has reviewed the October 2004, U. S. Department of Justice, Antitrust Division's "*Antitrust Division Policy Guide to Merger Remedies."*[43] Those remedy guidelines set forth the following guiding principles regarding merger remedies:

- The Antitrust Division will not accept a remedy unless there is a sound basis for believing a violation will occur.
- Remedies must be based upon a careful application of sound legal and economic principles to the particular facts of the case at hand.
- Restoring competition is the key to an antitrust remedy.
- The remedy should promote competition, not competitors.
- The remedy must be enforceable.
- A remedy is not effective if it cannot be enforced.
- The antitrust division will commit the time and effort necessary to ensure full compliance with the remedy.

The remedies that Staff has developed, discussed below, attempt to comport with these principles.

[43] Department of Justice, Antitrust Division Policy Guide to Merger Remedies, http://www.usdoj.gov/atr/public/guidelines/205108.pdf.

VI. Verizon/MCI Merger Analysis

The merger of Verizon and MCI impacts almost all aspects of the telecommunications market no matter how these components are defined. Staff's analysis focuses on four general markets: (1) Mass Market - Retail;[44] 2) Enterprise - Retail; (3) Transport - Wholesale; and (4) Special Access and High Capacity Loops - Retail and Wholesale. Staff's analysis also discusses Service Quality (both retail and wholesale), infrastructure investment, consumer issues and financial issues. Staff recognizes the potential impact of the merger on the Internet backbone market, but believes that a national perspective/analysis on this issue is required and that the implications of the merger on these markets should be reviewed by the Department of Justice and/or the Federal Communications Commission.

Mass Market Concentration – Retail

Parties' Comments

Verizon/MCI stress the fact that the availability of various forms of intermodal competition, including cable companies, wireless, Internet communications and broadband services, VoIP, and emerging technologies [Wi – Fi, Wi – Max, broadband over power lines (BPL) and satellite broadband] will insulate mass market customers from any anti-competitive harm resulting from the merger.[45] Verizon/MCI claim that these intermodal providers are major factors in the mass market now and will provide significant competition going forward.[46] The Petitioners further maintain that they have few overlapping lines of business; and therefore, foregone competition is not an issue.

CPB comments that the merger may reduce competition in the mass market. To offset this potential competitive harm, CPB and the Attorney General recommend availability of stand-alone or "naked" DSL and non-discriminatory access to the Internet backbone. The Competitive Carrier Group maintains that anti-competitive effects in all market segments will occur based on

[44] The retail telecommunications market, including both voice and data services, should be examined in terms of two broad groups of customers: residential/small business and medium/large business, including the institutional and government customers market.

[45] Verizon /MCI Reply Comments page 4.

[46] Verizon and MCI's *ex parte* Fact Report filed with the FCC on June 24, 2005. http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6517890996.

Verizon's position as the dominant local telephone company in the state, which will be enhanced once MCI is removed as one of Verizon's largest competitors. Qwest similarly contends that "The proposed transaction would eliminate all of the competition MCI provides to consumers...".[47]

Analysis

Staff performed two analyses to evaluate implications of the Verizon/MCI merger on the mass market. Both analyses measure market concentrations and both rely on HHI calculations, but the analyses are based on different data sets. The first analysis uses data from the FCC's June 2004 Local Competition Report.[48] The second analysis is based on data from Verizon's Performance Assurance Plan (PAP). Due to limitations in the PAP data which does not disaggregate residential and business data, the second analysis includes large business customers in addition to residential customers and small business customers. Although the latter provides a broader analysis of the market, the addition of large business customers should not have a marked affect upon the HHIs because the vast majority of customers in this data are residential and small business.

Analysis Based on FCC Data

Staff calculated the HHI index for the mass market using New York specific data that the FCC gathers for its Local Competition Report via its bi-annual survey of telecommunications providers.[49] Staff's analysis of the impact of the merger on mass market shares using the FCC data provides the following HHIs for the market as of June 30, 2004:

[47] Comments of Qwest Communications Corporation, Case 05-C-0237, page 1.

[48] The FCC defines the mass-market broadly to include residential/small business customers purchasing 1 to 3 lines.

[49] The FCC asks local exchange carriers with more than 10,000 lines in any state to report specific information on the number of voice and data customer lines or channels in the state. The FCC produces its bi-annual local competition report of this data on an aggregate basis but provides Staff with the survey's underlying raw New York specific data.

Table 2 - HHIs For New York Wireline and Data Services (Residential/Small Business)

	Wireline Voice Market HHI Res and Small Business Market	Data Service above 200kbs HHI Res and Small Business Market
HHI Before Verizon/MCI Merger	3,912	2,799
HHI After Verizon/MCI Merger	4,815	2,809
Change in HHI	903	10

It is important to note that both the wireline and data markets were highly concentrated even before the merger (i.e., the HHI exceeds 1,800). For example, Verizon currently dominates the voice market with a greater than 50% market share.[50] The analysis also illustrates that while there is little impact with respect to the broadband data market, the Verizon/MCI merger increases the wireline HHIs significantly; therefore, it is presumed the merger will result in a lower level of mass market competition in the mass market for voice (i.e., an HHI increase of almost 9 times the threshold 100 point change level). Such a significant change in mass market concentration as a direct result of a merger raises concerns.

To further evaluate the implications on the mass market, Staff also considered the effect of recent market trends on mass market HHIs. Petitioners claim that given MCI's de-emphasis of the mass market, MCI would not be a significant competitor even if the transaction does not take place.[51] However, according to equity analyst Bernstein Research, the consumer and small business sectors accounted for 44% of the MCI's revenue or $9.1 billion in 2004,[52] and, absent this merger, Staff would expect MCI to fight to retain that revenue stream, or perhaps find another merger partner who would. While Verizon/MCI claim MCI's consumer business is in a "continuing and irreversible decline," Staff notes that MCI's new customer additions show little sign of abating. Further, while MCI's mass market strategy would likely have transitioned from UNE-P, it could retain customers through wireline resale or use of a VoIP platform. A recent

[50] Industrial Analysis and Technology Division, Wireline Competition Bureau, Local Telephone Competition: Status as of June 30, 2004, see table 6. Http://www.fcc.gov/bureaus/common_carrier/reports/FCC-State-Link/IAD/com1204.pdf.

[51] Verizon/MCI Reply Comments, page 34.

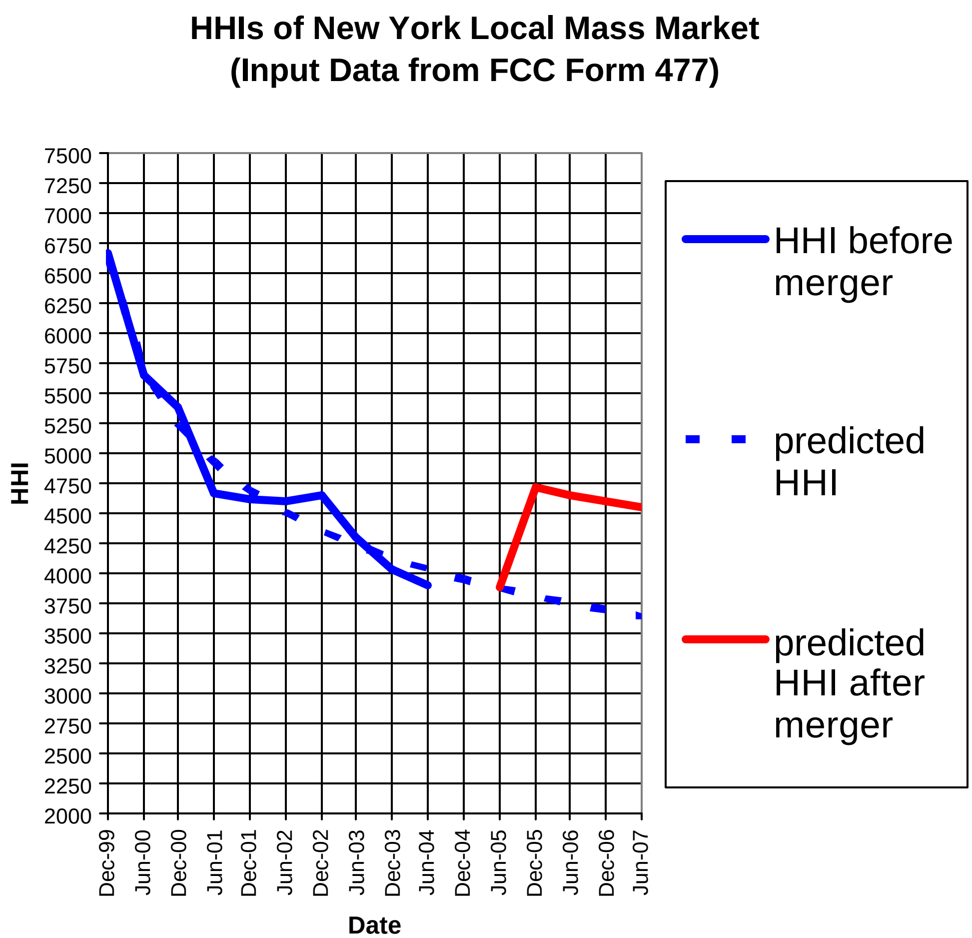
[52] Bernstein Research Call, Verizon & Qwest: Who Will be MCI's Valentine? Verizon Clearly MCI's Preferred Date; Combo Modestly Positive, Feb. 14, 2005, page 4.

check of the MCI website found that the company continues to advertise its bundled local and long distance "Neighborhood" package, and also its "Neighborhood Broadband Calling" VoIP service on its website. Staff inquiries to the contact number associated with the Neighborhood Broadband Calling ascertained that the service is currently available in New York.[53]

The following chart shows the significant decline in market concentration that had been occurring before the merger was announced. The estimated change in the trend lines post merger clearly indicates that the effect of the merger on mass market HHIs is to revert to higher market concentration levels of earlier years.

[53] MCI continues to offer its MCI Neighborhood calling packages to the mass market, a 2 month free offer for packages ranging from $29.99 to $49.99 per month. See http://www.mci.com

Figure 1 – Graph of Actual and Predicted HHIs Pre/Post Merger – Mass Market



Staff considered VoIP and wireless market shares but did not include them in its HHI calculations because, while cable companies are included in the FCC numbers on a very limited basis, the largest cable VoIP provider in New York did not report any voice grade lines in June 2004. Further, the FCC data excludes the impact of non-cable based VoIP providers like Vonage, AT&T, and Packet8.[54] Not including these providers may overstate the mass market concentration. While the presence of independent Internet-based VoIP providers (such as Vonage and Packet8) has not penetrated the residential and small business voice market enough to significantly lower the HHI in those markets,[55] we think these options represent an

[54] It should also be noted that the HHI analysis also excludes wireless providers.

[55] At the end of March 2005 Vonage had approximately 634,000 subscribers in the U.S. (according to information on Vonage's website). If the proportion of New York customers was roughly the same as the proportion of

increasingly viable alternative to traditional wireline services. These providers, coupled with cable company-based VoIP services, continue to aggressively compete with local telephone service in many areas of the state, and we expect this to accelerate as cable telephone providers resolve traffic termination issues.[56]

In addition, Verizon has only just recently provided a limited DSL offering without also requiring the purchase of local telephone service; new Verizon DSL customers must still purchase Verizon local telephone service in order to replace their telephone service with VoIP. The lack of such separate broadband offerings makes VoIP over DSL an imperfect substitute for local voice service, and while DSL VoIP may become a more important competitor in the mass-market in the future, at this time, the proposed merger makes an already concentrated residential and small business local telephone market even more concentrated.

Petitioners' claim that wireless service has significantly replaced traditional wireline service nationwide. However, the evidence that consumers view wireless as a substitute is mixed.[57] The FCC's report on wireless competition puts the percentage of people substituting wireless service for wireline service at between 3% and 6%.[58] The Wall Street Journal also reported that "while the number of wireless-only homes is increasing--close to 6% of all U.S.

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broadband connections in New York, that would mean Vonage would have approximately 7% of its customers in New York, (as calculated from the FCC's broadband statistics for June 2004). Vonage has approximately 45,000 customers statewide, a 1.8% market share.

[56] Cable telephone providers rely in large part on Verizon special service circuits to connect to E911 access points. Also, Verizon still remains the "middle man" in most carrier-to-carrier hand offs of local traffic between networks. Staff is not aware of any major communications companies with customers in New York that do not rely upon Verizon high capacity facilities to interconnect to the Verizon network. Staff is also unaware of any major communications company in New York, beside Verizon, to which all other communications companies are connected.

[57] A recent paper by Christopher Garbacz and Herbert J. Thompson, Jr. (World Demand for Mobile Telephony presented at the Rutgers University CRRI Eastern Conference, May 19, 2005) finds that while wireline and wireless service are substitutes in poor countries they remain complements in rich countries. Other papers find there is substitution: Ingraham, A.T. and J.G. Sidak 2004. “Do States Tax Wireless Services Inefficiently? Evidence on the Price Elasticity of Demand,” Working Paper. American Enterprise Institute, Washington, DC., Rodini, M., Ward, M.R., and G.A. Woroch. 2004. “Going Mobile: Substitutability Between Fixed And Mobile Access.” Telecommunications Policy 27: 457-476., and Ward, M.R. and G.A. Woroch 2004. “Usage Substitution between Fixed and Mobile Telephony in the U.S.,” PURC/London Business School Conference. London.

[58] "While firm data is difficult to come by, analysts estimate that 3% to 5% of wireless customers use their wireless phones as their only phone." Seventh Annual CMRS Competition Report (FCC Docket No. 02-179, page 32). See also Eighth Annual CMRS Competition Report (FCC 03-150) page 49 ¶ 102.

homes at the end of last year according to Forrester Research Inc.--the trend isn't accelerating as quickly as many experts predicted.'[59]

Petitioners also cite Internet communications, broadband services and emerging technologies such as Wi-Fi as market competitors. While these technologies may not offer significant competition in the marketplace for all customers, there is growing evidence that consumers increasingly view these new technologies as substitutes for wireline voice service.

Analysis Based Upon PAP Data

Petitioners assert that there are not market concentration implications, because MCI was de-emphasizing its presence in the mass market.[60] Staff identifies two weaknesses in Petitioners' position. First, market concentrations, measured by HHIs, are traditionally calculated based on current data, not projected data. Second, even if it is assumed that MCI, in the future, looses two-thirds of its New York market share, significant market concentrations remain.

In order to illustrate this situation, Staff performed two HHI analyses based on the April 2005 data contained in the Verizon PAP report for that month. The first scenario is based on actual data. The second scenario is based on the assumption that MCI would retain one-third of its customer base; one-third would have migrated to Verizon; and one third would have gone to other CLECs.

The majority of these access lines in this data, both retail and wholesale, are associated with mass market residential and small business customers.[61] The market share calculations that follow assume that the relevant market should be defined as the combination of the New York long distance and local exchange markets since Verizon has been competing on this basis since it was granted approval to enter the interLATA long distance business in December 1999. Staff made adjustments to the PAP market share data which assumes a single Cable/VoIP provider

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[59] Rhoads, Christopher, Cutting the Phone Cord Isn't as Popular as Once Predicted, Wall Street Journal, June 2, 2005, B1.

[60] While Petitioners suggest that MCI planned to de-emphasize mass market activities, we do not believe this represents an immediate, total withdrawal from the mass market. Staff has noted actions that represent reduction in mass market emphasis, but at the same time has noted recent activities that suggest MCI has been attracting new customers. For example, new order volumes have not declined dramatically and MCI is actively marketing the Neighborhood Calling Plans on its web site as recently as June 15, 2005.

[61] Although some enterprise customer lines are included in the PAP data, those lines were not readily separable in the Carrier-to-Carrier (C2C)/Performance Assurance Plan (PAP) reporting. However, the numb er is inconsequential, and our calculations relate to residence, small business and large business customers.

with a 5% share of the combined local/long distant market.[62] Below is a summary of these HHI calculations, based on these assumptions.

Table 3 - HHIs for Mass Market Pre/Post Merger (PAP Data)

	HHI Before Merger	**HHI After Merger**	**Change in HHI**
Scenario 1 - Using April 2005 data.	4,701	5,513	812
Scenario 2 -Using April 2005 data and assuming one third of MCI UNE-P customers would have been retained by MCI; one third would have migrated to Verizon, and one third would have migrated to other CLECs.[63]	5, 512	5,821	312

The results of Staff's mass market HHI calculations raise anticompetitive concerns. The pre-merger HHIs already show a highly concentrated market. Even in Staff's post-merger scenario where MCI retains only one-third of its customer base, the merger represents a significant increase in mass market concentration and the HHIs increase by more than the acceptable threshold. The "tipping point" for the change in HHIs to exceed the DOJ guidelines' threshold of 50 points is a pre-merger loss of 97% of MCI's UNE-P customers.

Mass Market – Staff's Conclusions

Based on the HHI merger analysis presented above, Staff tentatively concludes that the merger results in a significant increase in the concentration of providers in the mass market. In addition, MCI appears to be currently marketing (on its website) a VoIP-based roll out similar to that of AT&T, and is continuing to file tariff-based retail special promotional offerings. Therefore, it does not appear that MCI, for at least the short term, had a concerted plan to quickly exit the market post UNE-P.[64] Accordingly, Staff tentatively concludes that MCI would

[62] The 5% is likely high as a measure of non-Verizon network based mass market competitors, and treating this competition as being served by only one provider may overstate the HHIs.

[63] As for AT&T UNE-P customers, it is assumed that half would have migrated to Verizon and half would have migrated to other CLECs.

[64] The company's response to our recent inquiry indicating that it has no residential VoIP offering conflicts with our recent investigation of MCI's web site.

continue to be a mass market competitor to Verizon but for the merger, and that the increase in concentration should be addressed.

Mass Market - Remedies

Staff tentatively concludes that the following remedies might offer an avenue to offset the anticompetitive harm associated with the highly concentrated post-merger mass market and seeks comments on these proposed remedies, or other remedies which may address a concentrated mass market:

1) Would a Verizon offering of unrestricted "naked DSL" stimulate inter-modal competition?[65]

2) We seek comment on whether there are any impediments which impair a custmer's ability to switch between wireline, DSL and cable modem based telephone service providers? If so, how are they best overcome?.

3) Would freezing MCI's rates, terms and conditions for MCI mass market customers for 12 months from the date of the merger insulate MCI customers from the short term negative effects of the merger?

Finally, as more fully discussed later in this report under Retail Service Quality, the interrelationship of service quality, competition, and rate related remedies should be considered in the upcoming Comp III proceeding.

Enterprise Market-Retail

No single consistent definition of the enterprise market is used by the four companies involved in these mergers since threshold revenue levels and/or the number of lines distinguishing enterprise customers from other classes of customers may vary widely by company. However, the term enterprise market generally refers to large business customers, for example, Fortune 1000 corporations, mid-size businesses, and governmental and institutional customers. It is clear that there is a substantial market for the provision of retail services to large business customers as demonstrated by the fact that Fortune 1000 corporations spent an

[65] Such an offering would allow DSL customers to substitute wireline voice service with VoIP service without having to purchase local telephone service from Verizon. Verizon/MCI's Reply Comments argue that states cannot require ILECs to provide stand-alone DSL as a condition to boost intermodal competition.

estimated $63 billion on telecommunications services in 2004, accounting for one-fourth of the total U.S. retail market.[66]

Parties' Comments

Although Verizon/MCI maintain that the merger will not harm competition in the enterprise market, other comments raise concerns regarding the inevitable increased concentration in the enterprise markets. Conversent warns of the "significantly increased share of high-capacity local transmission inputs controlled by Verizon."[67] Conversent's comments maintain that the Verizon/MCI merger, in combination with the SBC/AT&T merger, provides a strong incentive for tacit collusion to refrain for competing in each company's dominant region. CCG notes the anticompetitive effects associated with the strong incentive to raise rivals' costs that the increased concentration in local transmission facilities creates. Qwest maintains that "the proposed transaction would eliminate all of the competition MCI provides businesses in the retail market in Verizon's local exchange territory, as well as the important competition MCI provides as a source of wholesale services used by other competitors in New York."[68]

Analysis

The merger of Verizon and MCI presents significant market concentration issues in the medium and large business, voice and data markets, based on the HHI measures Staff calculated. To gauge the effect of the mergers on the New York enterprise market, Staff relied on the data the FCC gathers for its Local Competition Report in its bi-annual survey of telecommunications providers.[69] Staff analyzed revenue shares of the New York enterprise market. The initial results of Staff's investigation confirm that AT&T and MCI are major players in the NY enterprise market.

Based on Staff's examination of June of 2004 FCC data, the following HHIs result:

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[66] Bernstein Research Call, U.S. Telecom: Superior Growth Prospects Make Enterprise Market a Key Battleground for U.S. Service Providers (January 6, 2005), page 3.

[67] Conversent Comments, page 2.

[68] Qwest Comments, page 1.

[69] The FCC defines "Medium and Large Business, Institutional, and Government Customer Market" as entities purchasing four or more lines.

Table 4 - HHIs for Large Business, Institutional and Government Market

	Wireline Voice Market HHI of Medium and Large Business, Institutional, and Government Customer Market	**Data Service above 200kbs HHI of Medium and Large Business, Institutional, and Government Customer Market**
HHI Before Verizon/MCI Merger	4,401	4,664
HHI After Verizon/MCI Merger	4,799	6,353
Change in HHI	398	1,689

Using the DOJ Merger Guidelines, the resulting HHIs indicate that these markets currently are highly concentrated; the proposed Verizon/MCI merger causes a significant change in the concentration of the voice and data markets for medium and large businesses, institutional, and government customers.

Staff notes that there is an issue regarding how to define these large business markets. Verizon and some of the commenters seem to view the enterprise market purely as a national market, and while Staff recognizes that a large portion of enterprise customers market their business on a nationwide basis, many other large enterprise customers are primarily New York State-based.

Staff presents two analyses; the first looks at the enterprise market on a nationwide basis (based on the multi-state presence of many large companies). Staff believes this perspective is appropriate because concentration in this market at the national level will be equally as evident in New York State. The second analysis looks at the market within Verizon's national footprint (as a proxy for New York State) in recognition of the fact that certain customers purchase services for businesses that are located primarily within New York.

Verizon's FCC testimony provides certain information regarding the impacts of this merger on the national enterprise service business. In the declaration of Robert W. Crandall and Hal J. Singer,[70] the authors present the following table in which Staff has inserted HHI calculations:

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[70] Attachment 2 of the March 11, 2005 Verizon/MCI Application to the FCC, WC Docket No. 05-75.

Table 5 - Revenue Shares of the Enterprise Services Business[71]

Company	Pre-transaction Market Shares	Pre-transaction HHI	Post Verizon /MCI Merger Market Shares	Post Verizon /MCI Merger HHI	Post SBC/ AT&T Merger Market Shares	Post SBC/ AT&T Merger HHI	Both Merger Market Share	Both Merger HHI
AT&T	15.8	249.64	15.8	249.64	0	0	0	0
SBC	13.1	171.61	13.1	171.61	28.9	835.21	28.9	835.21
MCI	11.8	139.24	0	0	11.8	139.24	0	0
Verizon	9.8	96.04	0	0	9.8	96.04	0	0
Sprint	6	36	6	36	6	36	6	36
Qwest	5.6	31.36	5.6	31.36	5.6	31.36	5.6	31.36
Bell South	5.5	30.25	5.5	30.25	5.5	30.25	5.5	30.25
Level 3	1.1	1.21	1.1	1.21	1.1	1.21	1.1	1.21
XO Comm.	0.8	0.64	0.8	0.64	0.8	0.64	0.8	0.64
Others	30.5	7.75	30.5	7.75	30.5	7.75	30.5	7.75
VZ/MCI	0	0	21.6	466.56	0	0	21.6	466.56
Total		764		995		1178		1409
Change in HHI				231		414		645

An evaluation of the data from Verizon's filing in the table above indicates that the merger of Verizon and MCI only would result in a relatively unconcentrated market that might not warrant further review. However, if the MCI/Verizon merger is considered after the SBC/AT&T merger takes place, the MCI/Verizon merger results in a market that is “moderately concentrated,” according to the DOJ's Guidelines. This change in HHI therefore suggests that the merger warrants further review.

Staff used the data from the prior analysis to analyze the impact of the merger on enterprise customers located primarily in New York State.[72] Verizon's national footprint is used as a proxy for New York State. Staff begins this analysis with the results from the table above. SBC, Bell South and Qwest revenues are removed from the Verizon footprint analysis since those RBOCs have a negligible amount of customer revenues in the Verizon service territory. The remainder of the competitors' revenues is allocated based upon the percentage of RBOC

[71] Table 5 from Crandall/Singer Declaration Revenue Shares of the Enterprise Service Business, Source: Nov. 11, 2003 Lehman Brothers Equity Research Report.

[72] The HHIs from the prior table are understated because they rely more heavily on non-New York providers.

customer access lines in Verizon's territory compared to the number of access lines in the combined Verizon, SBC, Qwest, and BellSouth territories .[73]

Our analysis indicates that the HHIs increase by 1,755 from a base before the merger of 2,924 to a post-merger HHI of 4,679. These HHIs would clearly exceed the DOJ Merger Guidelines threshold, and indicate a precipitous increase in market concentration.

Table 6 - Enterprise Market Share Analysis

Enterprise Market Share Analysis								
Assumes Verizon has $6.4 Billion Revenues in National Enterprise Market								
Verizon Footprint Market Revenues ($billions)								
		Change in HHI		=	1,755			
Before Merger					After Merger			
Market Total	15.07		2,924		Market Total	14.71		4,679
Company	Revenues	Share	HHI		Company	Revenues	share	HHI
AT&T	3.86	25.61%	655.86		AT&T	3.62	24.60%	605.15
SBC	0.00	0.00%	0.00		SBC	0.00	0.00%	0.00
MCI	2.88	19.13%	365.82			0.00	0.00%	0.00
Verizon	6.40	42.46%	1,802.77		Verizon & MCI	9.28	63.10%	3,981.65
Sprint	1.47	9.73%	94.58		Sprint	1.37	9.34%	87.27
Qwest	0.00	0.00%	0.00		Qwest	0.00	0.00%	0.00
Bell South	0.00	0.00%	0.00		Bell South	0.00	0.00%	0.00
Level 3	0.27	1.78%	3.18		Level 3	0.25	1.71%	2.93
XO	0.20	1.30%	1.68		XO	0.18	1.25%	1.55
Others	0.00	0.00%	0.00		Others	0.00	0.00%	0.00

In addition to an HHI review, entry barriers and market trends should be considered in determining whether they lessen any of the anticompetitive harms of the market concentration that the merger creates. Two analysts' reports seem to suggest that these mergers will cause falling prices in the telecommunication's industry to slow. Bernstein Research, in an April 5, 2005 Report, found:

> *Relative to AT&T's pre-closing performance risk, we believe the opportunity may be skewed to the upside (at least versus low expectations). We base this observation on the fact that SBC and Verizon have been two of the most aggressive (credible) bidders in recent enterprise Requests for Proposal (RFPs) as they have attempted to gain share/build scale in their nascent enterprise businesses over the past two years. With both companies having executed merger*

[73] The access lines used for this allocation were taken from Table 7.3 of the FCC Industry Analysis and Technology Division's May 2004, "Trends in Telephone Service" report.

agreements with the two largest incumbents, AT&T and MCI, respectively, we see the potential for a modest abatement in enterprise price compression while the mergers are reviewed (and afterwards).[74]

Baird/US Equity Research, in a February 14, 2005 Report on Verizon found:

Though the valuation seems fair for Verizon, MCI's long distance business will weigh down the company's consolidated growth rate, much as AT&T did to SBC. On the other hand, reducing the number of enterprise and long distance competitors should incrementally benefit the industry long-term.[75]

Damage from market concentration to the business and enterprise market can extend beyond the immediate market because business and enterprise service are usually a first step to building a full service network; this strategy has been used for the internet, local, and long distance networks.

Staff also believes that the telecommunications market transition to cable-based telephony is of little assistance to the enterprise market at this point in time since most small and medium-sized businesses are not "cabled-up" (i.e., current cable-based services are television rather than voice-driven) and larger businesses generally have T-carrier systems for their telecommunications needs, so there is no pressing requirement in this market for broadband services either. However, it is noted that such carrier systems are provided, for the most part, by Verizon and MCI, the merger partners. All of this information convinces us that a careful review of the anticompetitive impacts of this merger, in conjunction with the effects of the SBC/AT&T merger,[76] is needed if the public interest is to be served and competition preserved in the telecommunications industry in New York.

Finally, the following chart shows the significant decline in market concentration in the enterprise market before the merger was announced. The estimated change in the trend lines post merger clearly indicates that the effect of the merger on enterprise market HHIs is to revert market concentration back a few years.

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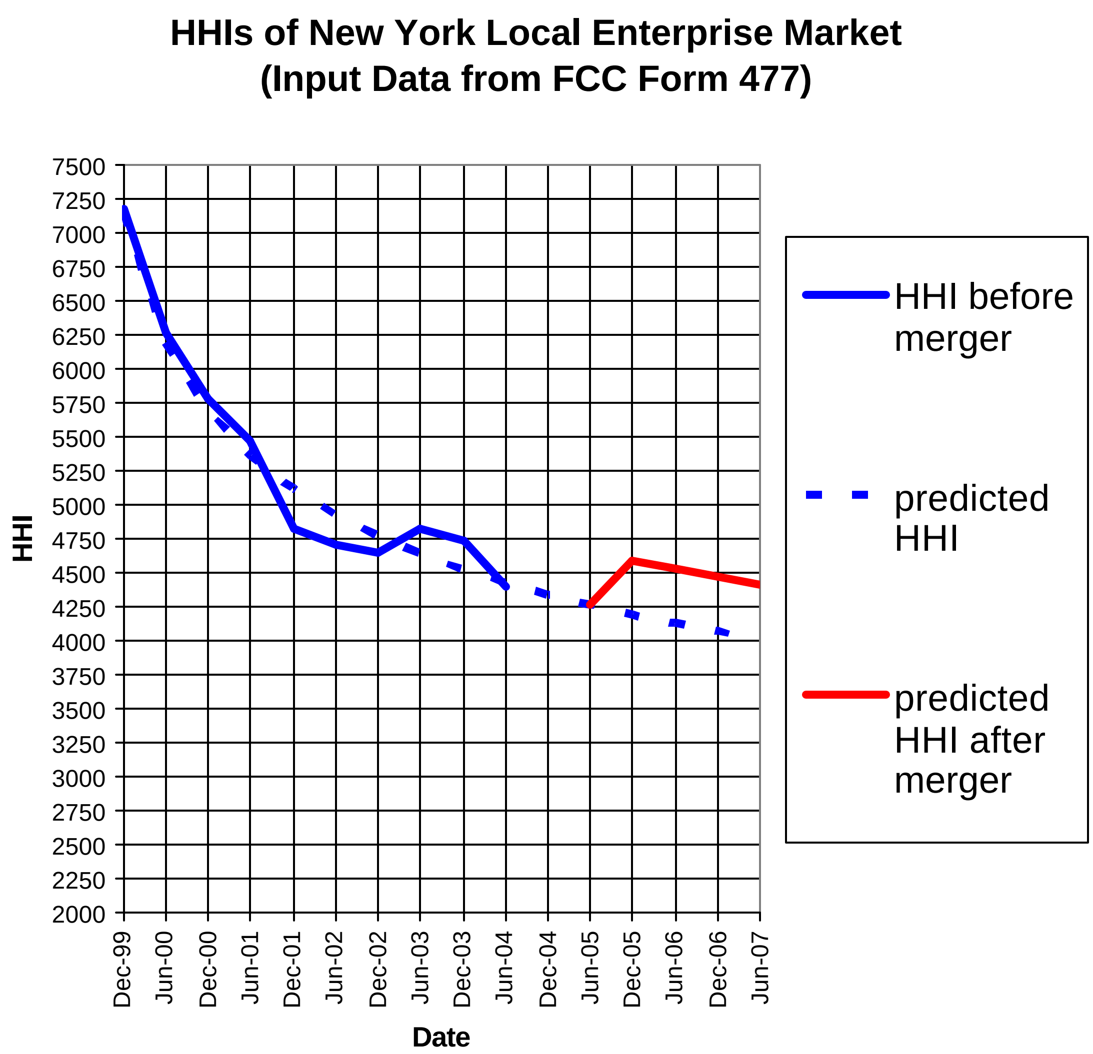
[74] Bernstein Research Call, SBC, BellSouth: Double Upgrade – SBC to Outperform, $29 Target; BellSouth to Market perform, $26 Target, April 5, 2005, page 4.

[75] Baird/U.S. Equity Research, Technology: Verizon Communications, Inc. Announces Acquisition of MCI, Feb. 14, 2005.

[76] As noted, Parties have suggested that the two mergers must be analyzed together to determine the full impact upon the competitiveness on the telecommunications market.

Figure 2 – Graph of Actual and Predicted HHIs Pre/Post Merger – Local Enterprise Market



Enterprise – Staff's Conclusions

Staff tentatively concludes that the proposed merger results in an increase in concentration in the enterprise market which exceeds the threshold levels in the DOJ/FTC Guidelines, and, therefore, requires countervailing remedies. We seek comment on our tentative conclusions.

Enterprise - Remedies

Staff tentatively concludes a direct retail based remedy is not required, believing it preferable to ensure reasonable retail enterprise market competitiveness by focusing on the terms and conditions associated with wholesale market offerings (such as the carriers systems mentioned above) that are used by competitive carriers to provide retail services to enterprise customers. We seek comment on whether addressing the wholesale markets adequately protects enterprise customers. If so, do the remedies proposed for the transport and special access and high capacity loops (see below) adequately address this issue.

Transport - Wholesale

Interoffice transport facilities, or trunks, allow for the transport of calls and data between telephone company wire centers. Staff's transport analysis follows the FCC's and the Commission's TRO transport route-by-route analyses. The TRO analyses focused on the factors driving the existence of "self-provisioners" along one transport route (e.g., Wire Center A to Wire Center B), and Staff believes that the FCC's route-specific approach is a reasonable analytical tool for analyzing the competitiveness of transport markets. In the TRO proceeding, Staff determined that of the 15,774 intraLATA routes that were potential candidates for dedicated transport competition in Verizon's territory, 135 of the Verizon routes had three or more transport providers, indicating sufficient competition. The subsequent TRRO methodology increased the number of transport routes deemed sufficiently competitive to 487.

Parties' Comments

Petitioners' maintain that the proposed merger will not have a "material adverse impact on the level of competition in the provision of high-capacity local services" [77] Verizon and MCI argue that the loss of overlapping fiber facilities will not harm competition. The Petitioners contend that the amount of overlapping facilities is small. The Petitioners also indicate that where Verizon and MCI do overlap, multiple other competitors also have facilities.[78]

Other parties raised concerns that the Verizon/MCI merger will result in an increase in concentration in the "high-capacity local transmission market," specifically transport and special access services. The Rural Independents note market power concerns with respect to the

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[77] Verizon/MCI Reply comments, page 58.

[78] Verizon/MCI Reply comments pages 29-30.

"combined transport facilities and access services of Verizon and MCI" and "urge[s] the Commission to recognize the threats imposed by large vertically integrated firms."[79] Conversent warns that the Verizon/MCI merger, in combination with the SBC/AT&T merger, provides a strong incentive for tacit collusion. Conversent and CCG also point out that the increase in concentration in the special access and transport markets provides strong incentives to raise rivals' costs. [80]

Transport Analysis

Staff has performed HHI calculations[81] for three transport market scenarios using underlying confidential data collected as part of the New York TRO proceeding (Case 03-C-0821). The first scenario analyzes the effect of the merger on all transport routes in the State. The other two scenarios analyze the impact of the merger on those routes deemed sufficiently competitive by the TRO and TRRO proceedings, which were tasked with identifying those market areas where a sufficient number of competitors would find it profitable to provision their own competing wholesale network facilities. The TRO and TRRO methodologies focused on identifying and counting the number of actual facilities-based wholesale competitors in a market area. If the actual number of competitors exceeds the TRO or TRRO "trigger," the market is considered to be unimpaired to competitive entry.

Under the first scenario, the pre-merger market is highly concentrated (HHI = 8,896), and the change in the HHI as a result of the merger suggests that further analysis of the merger should be undertaken (i.e., an HHI increase of 313). Clearly, the merger presents a problem for the competitiveness of the transport market under this scenario.

In the second scenario, the post-merger HHI indicates a highly concentrated market (HHI = 2,622), and the change in the HHIs indicates the merger should be examined further (i.e., an HHI increase of 959). Thus, transport market concentration is problematic even in the most competitive subset of routes in the New York metropolitan LATA.

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[79] Rural Independents Comments, page 6.

[80] Staff views the concept of "raising rivals' costs" in this situation to include anti-competitive acts such as delaying provisioning and repair intervals, increasing prices, and erecting other barriers to entry which are costly to overcome.

[81] The HHIs for all three transport scenarios were calculated based upon market shares reflecting the number of A-Z routes each carrier self provisioned as a proportion of all transport routes.

We also investigated a third transport HHI scenario which looks at the impact of the merger on those routes which were triggered by the FCC's TRRO impairment methodology. Below is a summary of the initial HHI calculations for the transport market under all three scenarios.

Table 7 - HHIs for Transport Market Pre/Post Merger

	HHI Before Merger	HHI After Merger	Change in HHI
MCI/VZ Merger Using Information on Transports in All LATAs for All Routes (assuming 2004 customer counts as is)	8,896	9,209	313
MCI/VZ Merger Only Routes Having 2 or More Competitive Transports in LATA 132	1,662	2,622	959
MCI/VZ transport analysis on TRRO triggered routes	2,077	3,486	1,410

The TRO triggers are met if a transport route exhibits economic conditions which would support three transport providers. There is a concern that post a Verizon/MCI merger, there may be a decrease in the competitiveness of the transport route because the MCI and Verizon transport facilities would now be under the control of a single economic entity. Furthermore, with the SBC/AT&T merger, it has been suggested that SBC/AT&T and Verizon/MCI might tacitly collude with respect to terms and conditions for transport on such routes. Staff tentatively concludes that the short run impacts of the merger on the competitiveness of transport markets should be addressed by merger-related remedies.

<u>Transport Overlap Analysis</u>

Verizon and MCI argue that the number of overlapping local facilities is small. The Petitioners contend that only 48 of the 524 wire centers served by Verizon contain overlapping local Verizon and MCI facilities, and that each of these 48 wire centers is served by an average of 10 competitors. Verizon relies upon this overlap analysis to suggest that facilities-based competition will not be harmed by losing MCI as a facilities-based competitor since the overlap of Verizon and MCI facilities is not significant.

To test this assertion, Staff performed a transport overlap analysis, based on those routes which were identified as being unimpaired under the TRO and TRRO methodologies. The first step was to update the transport data Staff collected in the TRO proceeding where Staff had identified 135 Verizon transport routes that had three or more transport providers of any type.[82] Using the TRRO analysis there are 487 intraLATA Verizon transport routes which are triggered. [83] Staff examined how MCI, Verizon, AT&T and SBC facilities overlap on these 487 "unimpaired" routes. The anti-competitive impacts of the merger are most troubling on those transport routes where Verizon, MCI, SBC and AT&T are the only transport providers.

There are 337 transport routes over which some combination of the four merger partners are the only transport providers (69.2% of the 487 TRRO triggered transport routes). In addition, Verizon, AT&T and MCI are the only transport carriers on 72 routes. The chart below illustrates the competitiveness of those transport routes triggered by the TRRO methodology.[84] Staff believes that the level of overlapping transport facilities, and the concomitant lack of additional transport providers on some of those routes with overlaps, indicates a significant anticompetitive impact of the merger(s) upon the New York transport market.

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[82] Staff has since updated its count to reflect the transport routes based upon the list of Tier 1 and Tier 2 wire centers shown on the last page of Appendix E of the new UNE Tariff (PSC No 5 as updated for the TRRO).

[83] The difference between the TRO and TRRO methods should be considered. The TRRO is only based upon the existence of the number of fiber based collocators at each end office and the number of business customers in the wire center. The TRO required that two wholesale competitors or three competitors actually self provision transport facilities between the central offices. When we compared Verizon's original transport list (based upon counting collocators) with the data Staff collected, we often found that those collocations were not being used to provide transport. (e.g., Broadview has numerous collocations, but still only purchased transport from Verizon).

[84] Individual company information for MCI, AT&T and SBC has been analyzed by Staff, but not presented in the chart below to protect its confidentiality.

Table 8 - Transport Route Overlap Analysis

	Total TRRO Unimpaired Transport Routes	Percent of Competitive Transport Routes
Competitive transport routes per TRRO methodology	487	100.00%
Routes on which a combination of VZ, MCI, AT&T and SBC are the only transport competitors	337	69.20%
Routes where VZ, MCI, and AT&T are the only three transport providers	72	14.78%

Transport – Staff's Conclusions

Staff tentatively concludes that the proposed merger substantially reduces the number of competitive transport routes. Further, the impact of the merger on competition is significant even for many of the routes considered to be the most competitive under the TRRO procedures.

Transport - Remedies

Staff seeks comment on the desirability and adequacy of the following potential remedies:

1) After the merger, should MCI be required to provide smaller carriers the same rates, terms and conditions for wholesale services that it provided pre-merger, or which are currently tariffed or offered under SPAs, for a period of 36 months from the date of the merger?

2) Would the availability of standard competitive rates, terms and conditions contained in commercial agreements between Verizon and competitive carriers be an effective tool to ensure the competitiveness of the transport market? How could this be accomplished?

3) Should the transport market-related retail and wholesale performance metric definitions be expanded to help identify and monitor the market concentration effects of the merger? Is there an enforcement or facilitation role for the Commission?

4) Is divestiture of the MCI New York transport network a practical and viable alternative to offset the increase in concentration in the transport market related to the merger?

Special Access and High Capacity Loops (Retail and Wholesale)

The numerous tariffs and service quality mechanisms that have been developed over the years for special access and high capacity loop services have generated confusion regarding the relevant definition of this product market. In general, this market includes engineered circuits which are used to connect large business customer buildings and large residential locations to Verizon end offices and competitor points of presence. These specially engineered high capacity circuits can be used to provide voice and/or data services.

Competitive Access Providers (CAPs) were one of the original types of facilities-based telecommunication industry competitors. Verizon-New York, MCI, AT&T, WilTel, Brooks Fiber, MFS, and Teleport, provid these high capacity access facilities to other carriers on a wholesale basis. MCI, AT&T, alarm companies, and other smaller competitive carriers also purchase these services from Verizon and other facilities-based providers to sell retail services to primarily large business customers (e.g., long distance, private line services, data/packet/VoIP services, alarm services).

Any discussion of Special Access and High Capacity services has the potential for confusion because there are questions relating to which circuits should be included in defining the relevant market. For example, special arrangements purchased by CLECs under federal and New York State access tariffs are considered wholesale services which are eventually used to provide services to retail customers; retail customers can also, themselves, purchase special services directly.

For the economic analysis of the merger on this market segment, Staff took an approach which is consistent with the DOJ Merger Guidelines definition of what should be included in a particular market. Those guidelines include all services that would alternatively be purchased and/or supplied in response to a non-transitory 5% price increase.[85] In Staff's view, this economic methodology results in a relatively broad market definition.[86]

Parties' Comments

Petitioners maintain that the proposed merger will not have a "material adverse impact on the level of competition in the provision of high-capacity local services."[87] Other parties are concerned with the increase in concentration in the "high-capacity local transmission market," specifically transport and special access services. US LEC expresses concern about the impact of the merger on the pricing, terms, and conditions of special access facilities. There are also comments that the proposed merger can be expected to harm New York consumers by significantly increasing the share of high-capacity local transmission inputs controlled by Verizon. Conversent maintains that the Verizon/MCI merger, in combination with the SBC/AT&T merger, provides a strong incentive for tacit collusion to refrain from competing in the others' dominant region.

CCG and Conversent point out that the increase in concentration in the special access market provides strong incentives to raise rivals' costs. CCG states that the merger will have significant anti-competitive effects in all market segments, including high-capacity loops and transport. CCG notes the strong incentive to raise rivals' costs that the increased concentration in local transmission facilities creates. Qwest maintains that "the proposed transaction would

[85] A "no facilities" situation reflects more than a 5% price increase (from a comparison of PSC and FCC vs. UNE tariffs). Customers do purchase under the higher priced tariffs if not allowed to purchase from the UNE tariffs. However, there have been numerous complaints associated with when a "no facilities" situation should be imposed and which were recently addressed by the Commission in its February 9, 2005 order in Cases 02-C-1233 & 04-C-0314.

[86] The C2C guidelines have parity metrics which compare Verizon's performance in provisioning and maintaining the higher priced specially designed "retail" circuits with Verizon's performance in provisioning and maintaining the lower priced specially designed "UNE" circuits. The excerpt from the C2C guidelines' "retail compare" table below indicates that UNE and retail specials are "like-to-like" and suggests they should be included in the same product market definition.

Wholesale Service	**Retail Analog**
Specials – Total	Retail Specials – Total
Resale Specials Other	Retail Specials Other
UNE Specials Other	Retail Specials Other

[87] Verizon/MCI Reply Comments, page 58.

eliminate the important competition MCI provides as a source of wholesale services used by other competitors in New York."[88]

Analysis of the Special Access and High Capacity Loop Environment

The commenting parties almost unanimously complain that Petitioners have not demonstrated that the merger is in the public interest,[89] nor have Petitioners addressed the anti-competitive aspects of the merger, and the market power concentrations that it creates. The parties clearly believe there is market power concentration in the wholesale transport, and local transmission markets, and Staff's preliminary analysis bears out these concerns. In very simple terms, MCI and AT&T are Verizon's two largest wholesale market competitors in that they have the largest competitive facilities-based networks in New York State (excluding Verizon) for the provision of transport and local transmission facilities. These existing networks are used to compete directly with Verizon for both wholesale and retail customers, and, according to commenters, Verizon's acquisition of one of two of its largest direct wholesale competitors has "potential anticompetitive consequences too severe to be ignored". [90]

Staff is able to provide some general observations that would lead us to believe that concentration in the Special Access and High Capacity market, post merger, would be problematic. AT&T and MCI are the largest competitive providers of these types of connections. The underlying circuit is essentially the same for various high capacity loop access products, whether purchased on a wholesale or retail basis; therefore, the markets for services relying upon high capacity circuits are converging. The following special services and high capacity loop services should be included in the relevant market definition.

- interstate special access
- intrastate special access
- UNE specials
- retail private line

Traditional retail services such as long distance and wireless, provisioned through wholesale special access arrangements, are now often bundled with basic local service offerings.

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[88] Quest Comments, page 1.

[89] According to the comments of the Competitive Carrier Group, the Commission has previously, in the Bell Atlantic-NYNEX merger Order, suggested that in order for a merger to be in the public interest, it must show that it will benefit ratepayers by preserving and promoting competition.

[90] CCG Comments, page 25.

Thus, the competitiveness of an increasingly intermodal retail market will also suffer because it is tied to these upstream wholesale service offerings. Carriers use special services/special access to connect Points of Presence (POPs) to Verizon central offices. Wireless carriers use high capacity circuits to connect cell towers to the traditional wireline network (PSTN). Packet cable providers and wireless providers use special arrangements to connect to E911 Public Service Answering Points (PSAPs). Competitive terms associated with AT&T's and MCI's special service offerings may evaporate post-merger as their interests converge with their RBOC merger partners. Staff believes that it will take time for the remaining high capacity loop providers, who are generally much smaller than either AT&T or MCI, to build out ubiquitous alternative offerings, especially to numerous potential cell tower locations. Cable companies may pass a majority of central office and cell tower locations, but we believe it will also take time for them to build out collocations.

In addition, according to several commenters, both AT&T and MCI provide not only alternative facilities, but they also provide discounted pricing arrangements for those facilities which are competitive with or significantly better than the terms or pricing arrangements that Verizon offers to many small carriers. Due to the nature of these facilities, there are inherent barriers to building and deploying new local fiber facilities (e.g., cost, obtaining conduit space, rights-of-way, and access to buildings). As a result of the merger, the current alternate supply and future additional construction will be compromised, and there is very little chance that another viable alternative provider, on the scale of an AT&T or MCI, will be available any time in the near (or perhaps even long) term. Commentors also suggest that cable based telephone service providers are not in a position to make a quick entry into the small and medium business markets. As previously noted, many business locations are not wired for television in the way residential buildings are. Thus, business locations often do not have cable facilities in place which can quickly be upgraded for the provision of packet cable telephone services. For these reasons, additional competitive opportunities in these very specialized markets may remain limited.

Staff further believes that the significant costs and lead time necessary to self-provision high capacity loop circuits is what has inhibited the development of a more ubiquitously competitive wholesale special services market. In addition, the Commission, as recently as 2001, stated that "a competitive facilities-based market for Special Services has yet to emerge and that Verizon continues to dominate the market overall."[91] By contrast, Verizon's recent statements[92] suggest that special access market conditions have radically changed since 2001.

Special Access and High Capacity Loop Overlap Analysis

The Petitioners have argued that there are not significant overlapping facilities, and Staff has analyzed the extent to which Verizon and MCI high capacity loop facilities overlap in New York State.

An overlap analysis identifies special access and high capacity loop physical facilities by owner and identifies Verizon and MCI facilities which share a common path. This analysis identifies where market concentration will increase once the merger is completed and the two companies share one economic interest.

Staff was not able to measure the overlap analysis of high capacity loops in the same manner as Staff performed its transport overlap analysis (which used data collected in the TRO proceeding). Because Verizon elected not to challenge the FCC's TRO impairment findings for loops, making collection of high capacity loop data unnecessary, and because we do not have responses to certain data requests, this information is not currently available. In the interim Staff relies on more generalized, though revealing, data to form its tentative conclusion.

Staff reviewed maps containing MCI's New York City (NYC) loop and data facilities.[93] These maps clearly show that there are large overlaps between Verizon and MCI local loop facilities, especially in the NYC area. Staff is attempting to supplement and quantify this preliminary conclusion through information requests which are outstanding at this juncture.[94]

Staff's traditional analyses for evaluating the resulting changes in special access/high capacity loop market concentration have not been done. For example, Staff has not calculated HHI figures for this market. It is possible that, given the particulars of the special access and high capacity loop market, there may be some competitive areas where unreasonable market

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[91] Cases 00-C-2051 and 92-C-0665, Opinion and Order Modifying Special Services Guidelines For Verizon New York Inc., Conforming Tariff, And Requiring Additional Performance Reporting Opinion 01-01 (issued June 15, 2001) page 9.

[92] See Verizon December 7, 2004 ex-parte filing in FCC WC Docket No. 04-313 titled "Fact Sheet, High-Capacity Facilities and Special Access," http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6516884385.

[93] May 26, 2005 MCI response to FCC Specification 6 (a) (1).

[94] Response to VZ20, VZ53, and Supplemental Request to MCI10.

power almost certainly exists. Staff offers the following to shed some light on the competitive dynamics of this market.

The Commission assessed the competitiveness of the high capacity loop market in the original competition proceeding (Case 28425). Following this competitive review, and resultant lightened regulation (e.g., limited pricing flexibility), almost two decades ago, a period of industry consolidation followed. The resultant performance in the market did not completely meet expectations, and this may have shaped part of this Commission's assessment of the market in 2001. This inter-temporal "case study" could be instructive as to how to view this latest step in the industry's consolidation efforts:

Verizon 1987:

Both economic and legal analysis demonstrate that market power or the ability to impede competition does not exist so long as alternative suppliers exist who have comparable or lower costs and the ability to expand supply without significant increases in costs. This lack of market power exists in the NYC metropolitan LATA due to the competitive presence of Teleport, microwave facilities and other suppliers of DS-1 or above capacity for exchange access.[95]

Special Access Market Developments 1987-2001:

The following acquisitions and mergers occurred between the original competition case analysis in 1987 and the Commission's institution of special services service quality requirements in 2001:

- AT&T merged with Teleport, one of the original New York access providers;
- WorldCom merged with MFS, another major Competitive Access Provider (CAP);
- MCI subsequently merged with WorldCom; and
- Brooks Fiber was purchased by MCI.

NY Commission 2001

Verizon's data, as well as the advantages attendant upon its historical incumbent position, indicate it continues to occupy the dominant position in the Special Services market, and by its dominance is a controlling factor in the market. Because competitors rely on Verizon's facilities, particularly its local loops, Verizon represents a bottleneck to the development of a healthy, competitive market for Special Services. In this situation, regulation is needed to assure the development of competitive choices, and good service quality when choices are not available. Accordingly, we find that a

[95] Case 29469, 1987 New York Telephone Company testimony of Dr. Jerry A Hausman.

> *competitive facilities-based market for Special Services has yet to emerge and that Verizon continues to dominate the market overall.*[96]

The Commission's findings regarding the concentration of the high capacity access market, together with the fact that MFS, Teleport, and Brooks Fiber represented a very large proportion of the competitive facilities-based special and high capacity circuit providers in New York State, suggests that caution is in order here as, post-merger, the market will be even more concentrated.

Specials and High Capacity Loops – Staff's Conclusions

Staff tentatively concludes that the acquisition of the second (MCI is roughly tied for second place with AT&T) largest wholesale provider by the largest provider of high capacity loop access services (Verizon) will significantly increase market concentration in the transport and special access markets. This may result in an unequal bargaining position for small carriers which, at some point, could result in the elimination of the favorable rates, terms and conditions currently offered by MCI to smaller carriers.

The merger may also eliminate or greatly reduce Verizon's incentive to enter into commercial agreements or contracts with small carriers for the provision of these services, or to make the terms of these agreements favorable in the future. Further, Staff tentatively concludes that the merger could affect business customers by potentially increasing T1 prices, and/or cause deterioration of retail service quality. Therefore, Staff's proposed special access and high capacity loop remedies are geared in part to avoid a situation where large business customers are harmed by the impacts of less competitive enterprise rates post-merger, regardless of the precision in how the market is defined.

In sum, the current field of wholesale service providers will be reduced by one major provider, and because AT&T is being acquired by another former RBOC, the potential for price or rate collusion, or discrimination in the provision of access for transport or special access facilities in favor of their respective affiliates, increases (to the detriment of small carriers and business customers). In addition, unless customers are located in close proximity to the fiber rings of remaining competitive high capacity special access providers in the market (e.g., Fibertech, Level 3), it may be difficult to get access to high capacity loops at competitive terms

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[96] Cases 00-C-2051 and 92-C-0665, Opinion No. 01-1, page 9.

and conditions that differ in terms or price from those that will be offered from the merged entity. We seek comments on Staff's tentative conclusions.[97]

Specials and High Capacity Loops - Remedies

Staff believes that to the extent that one of two major wholesale services providers is being absorbed by the largest wholesale provider, the anti-competitive aspect of the merger appears obvious. Therefore, Staff requests comments on what steps could be taken so that, post-merger, competitive carriers that have relied on MCI for the provision of wholesale transport and special access services are held harmless from any immediate, detrimental effects of the merger in terms of the provision and pricing of these services. With an eye toward implementing those steps which will also help to ensure that downstream retail markets remain competitive for enterprise customers, and to a lesser extent for the mass market, we seek comments on the following possible measures discussed below which are intended to give carriers that currently compete with Verizon and MCI an opportunity to strengthen their post merger business plans, and to construct additional facilities.

There are a variety of remedies that can be utilized to offset potentially harmful effects of a highly concentrated wholesale market post-merger. These fall into two distinct categories: structural and behavioral. The structural remedy in this case would be the divestiture of certain assets of the merging firms to avoid significant increases in market concentration; specifically, a structural remedy would involve divesting MCI's fiber loop network. Staff recognizes that much of MCI's high capacity loop plan is integral to its provision of business services, and that divestiture of those assets might make the transaction less attractive. Staff tentatively concludes that there are several behavioral remedies that could potentially mitigate the effects of the merger on the special services market, and seeks comments on their desirability and adequacy.

1) After the merger, should MCI be required to offer smaller carriers the same rates, terms and conditions for wholesale services that it provided pre-merger, or which are currently tariffed or offered under SPAs, for a period of 36 months from the date of the merger?

2) Should Verizon be required to extend for 36 months from the date of expiration, any interconnection agreements with other carriers that are due to expire within 12 months of the merger?

[97] Since no large business or enterprise customer "user parties" filed comments in the instant proceeding, we especially seek comment from this market segment.

3) Should the special services market-related retail and wholesale carrier-to-carrier performance metric definitions be expanded to identify and monitor the market concentration effects of the merger? Is there an enforcement or facilitation role for the Commission?

4) Would the availability of standard competitive rates, terms and conditions contained in commercial agreements between Verizon and competitive carriers be an effective tool to ensure the competitiveness of the special services market? How could this be accomplished?

5) Should divestiture of MCI's New York fiber loop network be considered as a practical and viable alternative to offset the increase in concentration in the fiber loop network market related to the merger?

Service Quality

Retail Service Quality

Verizon indicates that the merger will have no adverse impact on service quality, and that the Commission need not be concerned about the level of Verizon's service related capital investments or quality of service and as such no conditions are warranted. However, the Commission believes that the quality of telecommunications services is a public interest concern[98] and, in approving previous mergers, has generally incorporated service quality protections.[99] For example, to assure service quality improvements after the NYNEX-Bell Atlantic merger the Commission required NYNEX to commit to the hiring of between 750 and 1,000 additional employees in order to address existing service quality problems, and to maintain that employment level until service levels met the targets set forth in the PRP. In addition, there is also precedent for the Commission to require capital expenditures. For example, the Commission required NYNEX to invest an additional $1 billion in service-related infrastructure improvements over a five year period. One-half of that amount was to be spent on capital projects to improve service quality throughout New York State, in areas where service quality was significantly below standards. Today, Verizon is in the middle of an aggressive rollout of

[98] BA/NYNEX Merger Order, page 5.

[99] See the Bell Atlantic//NYNEX Merger Order and the Commission's Order deciding the Fairpoint Communications, Inc./Berkshire Telephone Corporation merger (Case 03-C-0972, Order Approving Acquisition Subject To Conditions (issued March 18, 2005).

Fiber to the Premises (FTTP); the company notes that the transaction will not affect its deployment plans.[100]

Verizon and MCI have also indicated that, post-merger, they will reduce the companies' workforce by approximately 7,000 employees;[101] however, the specific jobs that will be eliminated and their locations will not be made known until the transaction is completed.[102] Based on the relative percentage of employees, one might expect approximately 1,166 (17% of 7,000) job cuts in New York State. Verizon notes in its reply comments that while final decisions have not been made, "it is anticipated that the post-transaction company will reduce headcount in those areas which the company is able to provide shared services more efficiently – i.e., areas such as finance, legal and human resources" and that "there has been no suggestion that the transaction will result in service-affecting reductions in headcount."[103]

The Verizon/MCI Petition notes the merger will have no adverse effect on the quality of service of Verizon NY, or the regulated MCI subsidiaries, and there is no reason to impose any conditions on the acquisition.[104] For the last ten years, Verizon has been under regulatory plans that included service quality provisions. From August 1995 to March, 2002, Verizon was operating under a Performance Regulatory Plan (PRP). The PRP had provisions for service quality rebates if Verizon's service quality did not meet PRP objectives. The PRP was followed by a second incentive plan, the Verizon Incentive Plan (VIP) which began March 1, 2002. All but one of the VIP provisions ended March 1, 2004. The service quality provision expired a year later on March 1, 2005. The following provides a brief overview of Verizon's Service Quality performance under the VIP, and its most recent (March 1, 2005 – June 1, 2005) performance since the expiration of the VIP. This section also discusses potential impacts of the merger on service quality.

<u>Retail Service Quality – Party Comments</u>

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[100] Response to VZ25.

[101] WC Docket No. 05-75, Verizon Communications, Inc. and MCI, Inc. Applications for Approval of Transfer of Control, Public Interest Statement (FCC Public Interest Statement), Smith Decl., ¶3.

[102] Response to VZ13.

[103] Verizon/MCI Reply Comments, page 62.

[104] Verizon/MCI Petition, page 2.

The Commission received a number comments concerning service quality. CWA raises a number of issues that they believe the Commission should consider, including the need for a service quality plan with penalties, the need for Verizon to allocate specific levels of capital for their non-fiber network and requiring broadband build outs throughout the entire state. CWA also believes the Commission should address the issue of Verizon selling its upstate properties as well as a recommendation that the Commission institute a proceeding to ensure Universal Access. CPB similarly proposes that, if the Commission is inclined to approve the merger, it should impose service quality conditions[105] similar to the NYNEX and Bell Atlantic merger. The Assembly Committee on Corporations, Authorities, & Commissions similarly suggests that the approval of the Verizon/MCI merger should include service quality standards for Verizon because of service quality problems encountered during the VIP and PRP and that construction expenditure levels need to be included in the approval of the merger.

In response, Verizon takes issue with the need for a service quality "condition" contending that concerns regarding Verizon's service quality post merger are unfounded. The company notes previous mergers did not have negative impacts on service quality in New York, and there is no reason to believe this one will either. Verizon urges the Commission to reject these attempts to "reinstitute the command-and-control style of regulation" over Verizon and that any service-related penalty plan would be a substantial step backwards.

<u>Verizon's Performance under the VIP</u>

The VIP, approved by the Commission in February 2002, contained a three-year service quality plan based on five annual service performance targets based on service standards and customer complaints to the Commission. The VIP also included retail service quality penalties of up to $170 million per year. The service quality provisions of the VIP became effective on March 1, 2002 and ended February 28, 2005. Of the five VIP service targets, four are statewide averages. Overall, with the exception of a standard that measures the percentage of troubles cleared within 24 hours (OSS> 24 hours), Verizon's performance generally improved with each subsequent year of the plan.

[105] PULP does not recommend a service quality penalty program, but nevertheless raises the question of whether Verizon's service quality will suffer as a result of the merger.

Current Service Quality Regulation

VNY, like all local exchange carriers, is subject to monthly retail service quality standards. These metrics address, among other things, network reliability, timeliness of repair, timeliness of installation and call center responsiveness. Importantly, these performance results are geographically detailed, allowing Staff to follow trends, including any problem areas. Verizon reports these metrics on a monthly basis to Staff. In addition, Staff meets with Verizon on a monthly basis to review service quality results. The Commission has taken actions, irrespective of the existing regulatory framework, when it viewed problems with service quality. The 2004 Retail Service Quality Audit is illustrative of such an action. In July 2003, about the middle of the Verizon Incentive Plan, the Commission became concerned about retail service quality in light of capital reductions and workforce reductions. To address these concerns the Commission ordered an independent audit of Verizon's retail service quality.[106]

According to Commission regulations,[107] MCI, like other CLECs, currently is subject to the same service quality standards as Verizon, however is only required to report Customer Trouble Report Rate (CTRR) data. However, pursuant to Commission regulations,[108] MCI, which provides local exchange service primarily through UNE-P, received an exemption for the CTRR reporting requirement for its UNE-P lines, although it is required to report CTRR data for its facilites-based lines. Annual Commission service quality commendations are based on facilities-based lines, and it can be noted that MCI has not received a commendation for seven straight years.

Reporting of Retail Service Quality Data - Post-Merger

In response to a number of Staff's questions, Verizon and MCI note that after the transaction is completed, all MCI subsidiaries will become second-tier subsidiaries of Verizon and will continue to provide services to their customers in New York under the existing subsidiaries: MCImetro Access Transmission Services LLC, MCI WORLDCOM Communications, Inc., MCI WORLDCOM Network Services, Inc., TTI National, Inc.,

[106] Cases 03-C-0971 and 00-C-1945, Order Initiating Verizon New York Service Quality Proceeding (issued July 11, 2003).

[107] 16 NYCRR 603.4.

[108] 16 NYCRR 603.4 (f).

Teleconnect Long Distance Services and Systems Co. d/v/a Telecom USA, and Metropolitan Fiber Systems of New York, Inc.[109] As such, MCI's retail service quality performance data will continue to be separately reported as it is today pursuant to 16 NYCRR 603 and consistent with the waiver from routine reporting of certain service quality metrics granted to MCIMetro Access Transmission Services LLC by the Commission on December 19, 2001. Verizon's retail service quality data will be reported separately. No changes in measuring and reporting are anticipated.[110]

Retail Service Quality – Staff's Conclusions

Previous Verizon regulatory plans were enacted at a time when there was little competition, or competition was just emerging in New York. We tentatively conclude that today the sheer number of intermodal competitors for telecommunications services has significantly reduced the need for the incorporation/application of a VNY *statewid*e service quality rebate program and the requirement for a VNY *statewide* service quality rebate plan as part of the merger is not required.

Most customers who experience what they perceive as inferior telephone service quality or price have other options—they can change to a competing service provider in a matter of days, including VoIP, broadband or wireless carriers. Consumers exercising choice by changing carriers is not surprising. To the contrary, such actions are the natural evolution from a monopoly to a competitive market, and evidence of the Commission's goal to encourage competitive choice.

These competitive alternatives and opportunities, however, are *not* universally available. Competitive options, while increasingly available to New Yorkers in general, are simply not available to each and every New Yorker. For example, there may be no opportunity to take advantage of some broadband voice choices due to limited build outs, and/or other limits on the "reach of the technology." To the extent a service penalty rebate plan may be applicable, it may be more appropriate to target this group of "captive" customers. Staff believes proposals to identify and protect the limited group of customers that do not have choice are appropriate. Additional analysis on this issue, including the identification of the areas of limited competitive

[109] Verizon/MCI Petition, pages 5-6.

[110] Response to Information Request VZ22.

choice, will be undertaken in the Commission's recently initiated Comp III proceeding to review its existing regulatory framework. That proceeding will specifically focus on the relationship between competition and service quality.

> *… is there sufficient actual and potential competition for residential retail telecommunications service, including basic local telephone service, to prevent a firm from raising its price or providing poor quality service without suffering commensurate competitive losses? What measure of competition should we consider when determining whether retail pricing flexibility is appropriate? Can the Department's competitive index be used for this purpose?*[111]

The level of regulatory oversight must be informed by the extent of competition in the specific areas of the State. There may be instances where customers have adequate service quality; however they may not have any competitive alternatives. In this case, there would be an insufficient basis to lessen service quality oversight/regulation. Therefore, competitive and service quality "gateways" should both be considered.[112] Given the concerns raised earlier in our evaluation of mass market concentration, and concerns that Verizon may dedicate investment to more competitive areas at the expense of less competitive areas (due in part to a loss of merger related choice), we tentatively conclude that a rate related remedy may be in order. We seek comment on a framework that would limit Verizon's ability to increase rates in areas where neither a competitive nor a service quality gateway is passed. The details of this framework should be considered in the Comp III proceeding to ensure a full airing of all issues. Linking potential rate flexibility to these indices may provide a measure of protection to ensure that any loss of choice resulting from this merger will not be accompanied by reduced service quality and increased rates. For illustrative purposes, regulatory oversight might differ based upon service quality and competition as shown below:

[111] Comp III, Supra, 5-9. The index referred to in the quote is described in detail in the Comments of the New York State Department of Public Service 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 (filed October 4, 2004). http://www.dps.state.ny.us/fcc/FCC_10_04_04.pdf., pages 6-13.

[112] "Gateways" as used here, mean acceptable threshold levels of service quality and competitive alternatives, the specifics of could be defined in the Comp III proceeding.

Table 9 – Illustrative Framework with Service Quality & Competitive Gateways

Category	Competitive Gateway	Service Quality Gateway
1	Passed	Failed
2	Passed	Passed
3	Failed	Passed
4	Failed	Failed

Regulation for each of the four categories (1-4) above would be different, and would recognize competition and service quality. As noted, service quality and regulatory issues will be examined within the context of the Commission's Comp III proceeding. The above discussion is offered to support Staff's view that a service quality penalty plan is not required within the context of the merger. The Commission also has a number of options at its disposal to address declines in service quality, and it has not hesitated to employ them, irrespective of the regulatory plan in place, providing further safeguards against service quality degradation.[113]

The merger will have a negative impact on mass market competition. MCI, despite its claims to be exiting the local exchange market, still accepts consumers and also has a residential VoIP service available.[114] Staff also considers that continued deployment of IP-based advanced services by MCI may be hindered by Verizon disincentive to actively promote VoIP, a technology that could be used to compete against the ILECs' existing wireline voice product. In general, Staff does not propose a retail service quality penalty or incentive program, and agrees with Verizon that "customer flight" is a strong incentive for Verizon to address retail service quality. However, given that segments of the mass market may not have the opportunity to leave Verizon, remedies should be adopted that expand customer choice..

Verizon claims intermodal competition has been growing dramatically in New York and that there is significant VoIP competition in New York from cable companies (97% of the 7.5

113 For example, *Public Service Law* § 91 requires telephone companies to provide adequate service to consumers. The Commission retains the authority to initiate an investigation, direct independent audits or hold hearings in areas where service is not meeting expectations. Further, Staff routinely reviews and discusses with the telephone companies any service deficiencies and makes recommendations for formal actions if informal efforts do not produce desired results.

114 See www. mci.com "Neighborhood Broadband Calling."

million homes passed by cable systems in New York have broadband service available).[115] Some commenting parties disagree. For example, CCG argues that "VoIP is far too new and far too expensive (including the cost of the broadband connection and associated customer premise equipment) to represent a significant competitive alternative to traditional telephone service."[116]

Both parties oversimplify the impact of cable voice offerings on the local exchange voice market. Verizon, citing the penetration of cable systems throughout New York, ignores that incremental cost associated with purchasing VoIP service for customers without broadband.[117] Availability of broadband itself is not the key criteria. Many customers do not have broadband.[118] CFA states that 70% of households do not have broadband service, and therefore can not take advantage of VoIP calling. Many do not want to pay for broadband. Despite these considerations, Verizon concludes that broadband availability is sufficient to "defeat commenting parties' attempt to downplay the significance of cable competition in New York" and that this competition "constrains prices for wireline services provided by ILECs."[119]

Commenting parties, on the other hand, do not fully appreciate the rapid strides in competition. Since November 2000, Verizon has lost access lines every month, and those losses are increasing. For example, in early (January/February) 2004, the company was losing about 40,000 access lines a month. A year later they were losing over 75,000 a month.[120] Some of these losses have been to competitors and wireless, but increasingly such losses are to VoIP. Vonage has doubled its customer base every six months.[121] Time Warner is adding close to 15,000 new telephone customers a week.[122] Vonage is currently adding almost 20,000 subscribers a week[123] and has also recently started marketing to the small business market.[124]

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[115] This percentage is not inconsistent with Staff's estimate in the *Study of Rural Customer Access to Advanced Telecommunication Services*, See page 26.

[116] CCG Comments, page 18.

[117] Verizon also suggests that Instant Messaging and E-mail have displaced voice traffic as a commu nication alternative. (Verizon/MCI Reply Comments, page 19).

[118] FCC data suggest that by mid-2004, only about one-third of New York households had broadband services (Verizon/MCI Reply Comments, page. 15, Figure 4).

[119] Verizon//MCI Reply Comments, page 5.

[120] The source of this data is reports filed by carriers as required by 16 NYCRR 603.

[121] Verizon/MCI Reply Comments, page 21.

[122] Verizon Reply Comments, page 5.

[123] Broadband Trends, May 2, 2005, Report 05-1070.

What both parties ignore is the geography. Broadband is not available everywhere in New York State. DSL has distance limitations, and cable telephony is similarly limited to where cable companies have built out cable systems. Without question, customers in certain locations in New York have competitive options, including cable options, for voice. In some locations, however, competition does not exist. Thus, the question is not "Is there competition?" but rather, "Where is there competition?" Finally, Verizon/MCI ignore the additional costs incurred by consumers who wish to take advantage of broadband voice products.

Retail Service Quality - Remedies

Staff seeks comments on what, if any, remedies should be pursued that will ensure that service quality does not decline. Should Verizon expand the availability of broadband service to mass market customers through the unrestricted offering of DSL or "naked DSL"?[125] Verizon has indicated they are working to expand this offering to all customers; however, there may be a disincentive for Verizon to proceed quickly on this project. Should a deadline for Verizon to provide this type of service be imposed? We tentatively conclude that the Comp III proceeding is the appropriate forum to consider additional service quality remedies. .

Wholesale Service Quality

Parties' Comments

Level 3 Communications and US LEC state that MCI has taken a leading role in fighting for higher wholesale service quality. The merger of MCI into its strongest competitor would eliminate the "coattail effect" that other competitors have enjoyed since smaller competitors have far more limited resources and staying power to negotiate and arbitrate and therefore cannot challenge Verizon to the degree that MCI could. Level 3 and US LEC are further concerned that it is not clear at this time if there will be reductions in Verizon's capital budget for maintenance of outside plant and that additional information is needed to determine this.

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[124] VoIP Provider Is Preparing An Internet-Based Phone Service For Businesses, Vonage Goes To Work,, Denise Pappalardo, Network World, May 23, 2005.

[125] "Naked DSL" would allow customers to order DSL service from Verizon without being required to purchase local exchange service from Verizon as part of the package. As a result, the customer can then choose a VoIP provider, such as Vonage, to provide local telephone service.

Analysis

There is an overarching concern that in a post-merger environment, there may be less incentive for Verizon to address deficiencies in wholesale service quality, specifically for smaller carriers, and in particular carriers now obtaining services through commercial agreements. Currently, Verizon's wholesale service quality performance is measured by the New York State Carrier-to-Carrier Guidelines, performance Standards and reports, established in Case 97-C-0139 (the C2C proceeding).[126] Poor performance in certain C2C metrics deemed important to wholesale market competition can translate into penalties against Verizon in the Performance Assurance Plan (PAP), established in Case 99-C-0949. Verizon has suggested it will not include the measurement of UNE-like products offered through commercial agreements in future wholesale performance reporting. Therefore, carriers purchasing products from Verizon through interim and commercial agreements may not be afforded the protections offered by the Commission in the C2C proceeding or the PAP.

Ultimately, the success of multiple wireline carriers and intermodal competition will provide the most efficient mechanism to apply downward pressure on retail rates. Therefore, it is important to address to affects of the merger on the opportunity for carriers to receive adequate wholesale service quality. Absent carriers having the size and resources of AT&T and MCI, the remaining CLECs will be hard pressed to assemble the resources required to address any wholesale shortcomings resulting from substandard wholesale service quality.

Also very important is the need to address the heightened vulnerability that medium sized business customers will face for high capacity circuits once the merger is consummated. As discussed in the special services/high cap loop section, these business customers are particularly at risk of anticompetitive impacts given the lack of cable based alternatives currently available to them. Losing MCI as a major wholesale competitor for the provision of T-1 circuits may have an effect on the quality of high capacity services provided to retail business customers.

Another post-merger concern is how products and services currently purchased by MCI will be measured and reported in the C2C proceeding and what impact the reporting will have on surviving measurements and standards. It is also likely that merger-driven modifications to the

[126] The C2C Guidelines measure performance against an established absolute standard or against parity with performance that Verizon provides to its own retail customers. Whether MCI products will continue to be reported separately or reported in Verizon's retail parity data will impact measurement against remaining CLEC performance data.

C2C or its impact on wholesale performance reporting will carry over to the PAP, which relies on C2C metrics to assign penalties for poor wholesale service quality.

Wholesale Service Quality – Staff's Conclusions

Staff tentatively concludes that the merger has the potential to impact wholesale service quality and availability. Additionally, Staff acknowledges the concern that Verizon may have less incentive to fulfill its obligations to provide good wholesale service quality in a post-merger environment.

Whole Service Quality – Remedies

Staff tentatively concludes that, given the increased reliance on the wholesale market to provide protections for the retail markets, the Commission needs to expand its monitoring of the overall level of performance in the wholesale special services/high capacity market. Staff believes the following remedies should be considered in order to assure that the overall level of performance is known and that Verizon properly attends to its obligations to provide good service to CLECs post-merger. Staff seeks comment on the desirability and adequacy of these proposals:

1) Should MCI's service quality performance be reported separately in carrier-to-carrier reporting?
2) Should service quality performance be reported to Staff for wholesale products and services purchased by a carrier through commercial agreements?
3) Would future commercial and interconnection negotiation processes and resultant agreements benefit from an expanded list of collaboratively developed wholesale special service and high cap metrics to draw from? How will adequate and nondiscriminatory service performance be enforced?
4) Does the Commission need to implement a process to ensure the integrity of the reporting systems for transport and special services?

Consumer Issues

Issues regarding the obligations of Verizon and MCI to their customers arise as a result of the proposed merger. Several commenters identified specific concerns regarding the mass market customers who will be affected by the Verizon/MCI merger.

Parties' Comments

The New York State Attorney General points out that the proposed merger threatens to "have an adverse impact on the prices and/or services offered by the merged entity" and that "potential harm to consumer choice, consumer access, and future innovation in the telecommunications industry presented must be recognized and prevented in the Commission's review."[127]

The Competitive Carrier Group (CCG) maintains that the Verizon/MCI Joint Petition does not demonstrate that local residential and small business customers will have more choice, or even as much choice as currently enjoyed, as the result of MCI's exit from the mass market. CCG contends that Petitioners Verizon and MCI do not address the concerns of the mass market customer choosing to rely on traditional landline telephone service. In addition, CCG raises the issue of affordability of bundled service (local, toll, and additional services such as broadband) versus the cost of stand alone local telephone service in New York. As CCG states, "a question of fundamental importance to the Commission is whether in all of its discussions of the availability of $50 to $100 packages of services, Verizon has forgotten that most of its customers use $25 telephone service."[128]

PULP raises a concern regarding continuation of the Lifeline program which has experienced a drop in subscribership over the past three years, jeopardizing millions of dollars in federal funds available for Lifeline services in New York. PULP maintains that specific enrollment goals should be required in the merger agreement that are accompanied by strong rate and penalty incentives.

CPB states that MCI continues to actively market its telephone service to residential and small business customers in New York. According to CPB, MCI was marketing its Neighborhood package, with two months of free service for every subscription to a local and long distance package, as of late April 2005.[129]

[127] Attorney General Comments, page 7.

[128] CCG Comments, page 16.

[129] CPB Comments, page 9.

Customer Notification – Staff's Conclusion

MCI has a significant number of local exchange customers in New York. Although MCI already notified its enterprise customers of its proposed merger with Verizon,[130] MCI has yet, to Staff's knowledge, notified its residential and small business customers. This lack of customer notice raises several concerns.

The Verizon/MCI Joint Petition states that there is no current plan to transition Customers or change the rates, terms, and conditions of telephone service for those customers.[131] Instead, according to Verizon, "such changes might be made at a later date…."[132] In the interim, MCI customers who actively chose MCI as their telephone service provider based on price, service quality, services provided, or other criteria, have no information despite the likely impact of the merger on them. Without such information, customers might assume that they will automatically be switched to Verizon. This assumption is contrary to a customer's right to choose local and long distance providers. There is a need for notice to residential and small business customers about the merger and its likely affects in addition to the enterprise customers already notified.

Customer Notification – Remedies

Staff tentatively concludes that MCI's residential and small business customers should be properly notified regarding 1) the proposed merger and 2) any potential changes post-merger that will affect telephone service plans or rates. Notification should be discussed with Staff prior to its issuance. Staff seeks comments on customer notification procedures. No other remedies are warranted.[133]

Customer Service/Complaint Handling

Staff has not received information solicited regarding MCI's post-merger complaint handling process. However, MCI's retail service quality performance data will continue to be separately reported pursuant to 16 NYCRR 603 and Staff infers from this that the customer service/complaint function will remain separate as well because measures such as customer

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[130] Verizon SEC filing No. 001-10415 (May 23, 2005).

[131] Verizon/MCI Petition, page 6.

[132] Responses to VZ16-45 and MCI17-21 in a letter dated May 27, 2005.

[133] Staff tentatively concludes that Lifeline enrollment is not directly impacted by the merger, and Verizon confirms that the transaction will not affect Verizon's Lifeline program in any way. Therefore, no remedies associated with Verizon's Lifeline program are being proposed.

trouble report rate, initiated by customers calling into a call center, would continue to be separately tracked and measured.

b

Financial Issues

The Commission has evaluated numerous mergers and acquisitions in recent years and financial issues, including rates, have often been a major issue. The *Telecommunications Act of 1996* and various related steps taken by the Commission have resulted in significant competition for local telephone service in Verizon's New York service territory. As a result, the Commission recently has given Verizon's financial situation, including earnings, less weight when making decisions. However, the transition to competition is not yet complete and financial matters, most notably as they relate to Verizon's ability to provide adequate service to its New York customers, should be considered by the Commission when deciding if the proposed transaction should be approved. Verizon's petition only tangentially touches on financial issues.

Verizon has estimated the purchase price to acquire MCI to be approximately $8.6 billion, which is about twice the book value of MCI's net assets at March 31, 2005.[134] As the "Total shareowners' investment" on Verizon's consolidated balance sheet at March 31, 2005 was about $38.0 billion,[135] the acquisition must be considered significant by any standard. Further, MCI has only recently emerged from bankruptcy, and the financial scandals that plagued MCI's predecessor are well documented. Verizon's 9.9 million regulated domestic access lines in New York State represent approximately 19.7% of Verizon's regulated domestic access lines.[136]

Synergies

Background

One of the main reasons for mergers and acquisitions is that they produce cost savings through economies of scale and scope as well as opportunities for revenue enhancements. These are commonly referred to as synergies. The Commission has often conditioned the approval of

[134] Form S-4, Registration Statement Under The Securities Act Of 1933, submitted by Verizon with the Securities and Exchange Commission (SEC) on June 2, 2005, pages 119-20. The merger agreement between Verizon and MCI provides for potential adjustments to this purchase price under certain conditions.

[135] Id., page. 117.

[136] FCC Report 43-08, the ARMIS Operating Data Report, Table III - Access Lines in Service by Customer.

mergers and acquisitions on a sharing of the expected synergies with customers by imputing them in an associated rate case.[137] Verizon's petition states the transaction will have no effect on rates but does not directly address synergies.[138] However, as discussed below Verizon has publicly stated that the transaction is expected to produce significant cost savings and revenue enhancements.

Only PULP specifically addressed potential synergies from the transaction. PULP began by noting that some states have laws requiring merging utility companies to demonstrate affirmative, concrete benefits to consumers as a condition of merging. PULP contends that Verizon attempts to skirt all Commission review of the transaction and offers no concrete benefits to New York customers. PULP recommends that in determining the public interest, the Commission adopt conditions that ensure New York customers benefit no less from a completed merger than the customers of any other state.[139]

Verizon responds that the Commission is uniquely qualified to determine how the transaction serves the "public interest" in New York and should not import conditions imposed by other states, particularly where the state is acting pursuant to statutory requirements that the New York Legislature has not seen fit to impose on New York utilities. Verizon finds PULP's proposal "particularly outrageous," noting that Verizon is suffering substantial losses in New York and, given its deteriorating financial condition, any savings that can be attributed to the New York operations are sorely needed for Verizon to continue those operations.[140]

Projected Synergy Savings

As indicated above, Verizon has publicly stated that substantial synergy savings are expected to result from the transaction. For example, Verizon has stated the that it "believes that the potential annual pre-tax operating savings and revenue enhancements following the closing of the merger will reach approximately $500 million in year one, $800 million in year two, and

[137] See e.g., Case 96-C-0603 et al., NYNEX Corporation and Bell Atlantic Corporation – Merger, Opinion 97-8 (issued 5/30/97); Order Approving Proposed Merger Subject to Conditions (issued March 21, 1997) and Case 98-C-1443, Petition of Bell Atlantic Corporation for Approval of Agreement and Plan of Merger with GTE Corporation; Order Granting Approval of Merger (issued August 12, 1999).

[138] Pages 2 and 8 of Verizon's Petition indicate the transaction will have no affect on rates. However, page 14 of the petition notes the merger will “eliminate duplicative expenses” and “create operational efficiencies.”

[139] PULP Comments, page 10.

[140] Verizon Reply, Comments, pages 69-70.

will ramp up to $1.1 billion in year three and beyond."[141] Verizon has also stated that the transaction will result in total benefits with a net present value of $7 billion, reflecting cost savings and incremental revenues.[142] Verizon believes that these synergies can be achieved based on its track record combining NYNEX Corporation and Bell Atlantic Corporation in 1997 as well as GTE Corporation and Bell Atlantic Corporation in 2000. Verizon estimates that it will spend $3.0 to $3.5 billion over the next three years to achieve the projected merger benefits, and that additional synergies are expected to come from, among other things.[143] Included are:

- General and administrative expense reductions.
- Information Technology (IT) systems improvements.
- International operations savings.
- Network operations savings.

Verizon indicates that revenue enhancements from operating Verizon and MCI together are expected to come from, among other things:

- Retaining existing customers and selling additional services to enterprise customers.
- Offering new services to small and mid-size businesses.
- Offering wireless services to enterprise customers.

Staff Analysis

Staff requested and Verizon provided the workpapers and other documents supporting the Verizon public claims regarding synergies expected from the transaction referred to above. However, Verizon contends that much of the information in those documents is highly sensitive and only made them available for inspection by Staff subject to the Protective Agreement in place in this proceeding. Verizon's response to VZ1 also included:

> Note that the dollar amounts in the spreadsheets do not equal the dollar amounts in the power point presentation. This is so because the dollar amounts in the spreadsheets reflect estimates developed over time by subject matter experts ("SMEs") based on their examination of possible synergies. Those SMEs submitted those estimates for review and the estimates were risk adjusted to account for contingencies that might prevent achievement of the estimated synergies.

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[141] Form S-4 filed by Verizon with the SEC June 2, 2005, page 53.

[142] WC Docket No. 05-75, DA 05-762, Verizon/MCI FCC Merger Petition, Declaration of Gustavo E. Bamberger, Dennis W. Carlton and Allan Shampine, page 20. Verizon indication that it expects that the net present value of synergies from the merger to be about $7 billion.

[143] Form S-4 filed by Verizon with the SEC June 2, 2005, page 26.

As a result, Staff often could not determine precisely how Verizon determined many of its estimates. Staff also discovered some estimates were inconsistently determined. Further, Staff found that the expected costs are a combination of items, some of which will be expensed and charged against earnings in the year incurred, and others that will be capitalized and charged against earnings over the life of the plant. Further, no breakdown was provided by subsidiary and/or jurisdiction. Thus, absent additional information from Verizon, Staff cannot determine with any precision the amount of synergies applicable to Verizon's New York intrastate operations.

To properly evaluate the impact of the synergies on Verizon's New York intrastate operations, a comprehensive understanding is needed of Verizon's New York intrastate financial condition as well as current and projected earnings. Verizon's petition did not include historic or projected financial data for Verizon's New York operations. [144] However, Verizon has reported the following intrastate returns on common equity (ROE) for its New York operations for the last three years.[145]

Table 10 – Verizon Intrastate Return on Common Equity (2002-2004)

2002	-11.0%
2003	-40.3%
2004	-36.2%

As a part of its ongoing review of Verizon's financial operating results, Staff reviews Verizon's calculation of these ROEs. However, this review does not approach the in-depth analysis normally performed by Staff in a rate proceeding. Nonetheless, based on this limited review, Staff has generally concluded that while adjustments that would have the effect of increasing Verizon's intrastate ROE were warranted, these adjustments were unlikely to bring Verizon's intrastate ROE above 0%, especially in 2003 and 2004. As demonstrated in the chart below, these depressed ROEs are primarily the result of falling operating revenues.

Table 11 – Verizon Revenues by Telecommunications Segment (2001-2004)

[144] Verizon did attach to its February 25, 2005 MCI's 2003 Form 10K and 2004 3rd Quarter Form 10Q as well as Verizon 2003 Form 10K, 3rd Quarter Form 10Q and Verizon 2003 Annual Report.

[145] Verizon 2002, 2003 and 2004 Annual Report to the Commission, Schedule 10.

Revenues in $ Billions	2001	2002	2003	2004	Change 2004-2001	% Change
Local Network Services	$4.0	$3.9	$3.5	$3.1	($0.9)	-22.5%
Network Access Services	0.3	0.2	0.2	0.3	0.0	0.0%
Long Distance Network Serv.	0.2	0.2	0.2	0.2	0.0	0.0%
Miscellaneous	1.0	1.0	0.9	1.0	0.0	0.0%
Total Operating Revenue	**$5.5**	**$5.3**	**$4.8**	**$4.6**	**($0.9)**	**-16.4%**

As indicated above, a precise calculation of the impact of the expected synergies on Verizon's intrastate ROE cannot be made by Staff at this time. However, the response to VZ1 included an estimate of the effect of the expected synergies on the merged companies' consolidated income statements for 2005 through 2014. Based on our limited review, we conclude this provides an appropriate basis for making general observations about the impact of the synergies on Verizon's New York intrastate ROE.[146]

Verizon estimates the transaction will not impact the merged companies' income statement in 2005 and will have only a minimal impact on net income in 2006. The merger begins to noticeably improve net income in 2007 but it is not until 2009 that the improvement reaches a level where it might have a material impact on Verizon's New York intrastate ROE. As indicated above, Verizon's current New York intrastate ROE is below what it would be allowed in a traditional rate proceeding. Thus, there appears to be no basis, at this time, for the Commission to institute a rate proceeding or require Verizon to pass along the savings to customers as PULP suggests. Staff will continue to monitor Verizon's New York intrastate ROE and can recommend the Commission take action if actual results indicate these general conclusions may be wrong.

There is another reason for not automatically passing along the synergy savings as PULP suggests. In three separate Orders recently issued, the Commission clearly indicated that it is changing the way it views Verizon's earnings in light of the increased competition Verizon now faces.[147] Further complicating the use of Verizon's intrastate ROE, is the changing nature of the telecommunications market. For example, when the Commission set Verizon's rates using

[146] Income Statement impacts were not provided in Verizon's response to FCC question VZ20, which, as noted above, reflects an update of the amounts provided in the response to VZ1.

[147] Case 02-C-0959, Order Allocating Property Tax Refund (issued March 12, 2003), page 4; Cases 05-C-0091., et. al. Order Approving Transfers (issued May 20, 2005) pages . 5-10; and Case 05-C-0510, Order Approving Transfer (issued June 15, 2005), pages 4-5.

traditional rate of return regulation, local telephone service was the primary service provided to customers. However, today local telephone service is generally just one part of a package of services that can also include services like long distance, wireless, DSL and television (cable or satellite). Although the vast majority of the revenues from these services are closely linked to local telephone service and the built-in advantage that Verizon continues to enjoy to at least some extent, they are not considered at all in the intrastate ROEs presented above. Moreover, the Commission has never fully considered if, and if so how, these revenues should be considered when assessing Verizon's New York earnings. However, this is not the appropriate forum for deciding such generic, far-reaching issues. Instead, they should be considered in the Comp III proceeding recently instituted to revisit the Commission's regulatory framework in light of the changed telecommunications environment.

Accounting for the Transaction

To ensure that the financial integrity of the regulated entity is maintained, the Commission's approval of mergers and acquisition has often included a condition that customers be insulated from the costs to consummate a merger and the same is recommended here.[148] These include the direct administrative costs of completing the transaction, which are relatively easy to identify and include legal and filing fees. Verizon will also be required to make additional charges to earnings for the proposed transaction. Verizon will be accounting for this transaction using the purchase method of accounting, which it must use in order to comport with generally accepted accounting principles (GAAP).[149] These additional charges may be substantial.

Under the purchase method, Verizon must first allocate the total purchase price to MCI's net assets at their fair values on the date the merger is closed. If there is any remaining amount,

[148] See Case 99-C-0530 - Joint Petition of Global Crossing, Ltd. And Frontier Corporation for Approval of the Acquisition by Global Crossing Ltd. of all the Outstanding Shares of Frontier Corporation's Common Stock, Order Approving Petition (issued December 1, 1999), Ordering Clause 2 and Case 00-C-1415, Joint Petition of Global Crossing Ltd. And Citizens Communications Company for approval of the transfer of capital stock of their New York ILECs (Frontier of Rochester, AuSable Valley, New York, Sylvan Lake, and Seneca-Gorham) and Frontier Subsidiary Telco, Inc. to Citizens Communications Company, and for Other Authorization Needed, Order Approving Transaction With Conditions (issued May 11, 2001), Ordering Clause 2.

[149] GAAP are the principles, rule, procedures, and conventions of accounting practice that companies must follow to meet the SEC's requirements. GAAP is defined by a hierarchy of rule-making authorities and promulgated by various types of pronouncements. The current standards setting organization with the highest ranking authority is the Financial Accounting Standards Board (FASB). The rules accounting for mergers and acquisitions are provided in FASB Statement No. 141, Business Combinations (issued June 2001).

Verizon must record it as goodwill. As noted, Verizon indicates that the acquisition price will be $8.6 billion, which Verizon estimates will require it to write-up MCI's intangible assets $0.7 billion (net of deferred taxes); increase the value of long term debt $0.3 billion, and record $4.1 billion of goodwill. As a result, Verizon will incur additional amortization expense over the useful lives of certain intangible assets acquired, and to the extent the value of goodwill or intangible assets were to become impaired, Verizon may be required to make charges relating to the impairment of those assets.[150]

Verizon's New York utility customers should also be insulated from the imposition of any charges relating to accounting for the acquisition using the purchase method of accounting. Thus, we recommend the transaction only be approved on the condition that none of the merger related costs be reflected on the books of Verizon's New York regulated operations. Further, none of the additional equity resulting from recording the transaction under the purchase method should be considered in any derivation of Verizon's New York intrastate ROE.

Business/Financial Risk

The impact of the proposed transaction on Verizon's creditworthiness could have repercussions for Verizon's New York telecommunications customers. With a market capitalization of approximately $100 billion, it is not expected that the acquisition of MCI will impair Verizon's ability to attract the capital necessary to upgrade Verizon's wireline infrastructure in New York. However, based on statements made by the rating agencies, we are concerned that Verizon's securities could be downgraded, which could lead to higher capital costs for the portion of Verizon's operations regulated by the Commission. Also the proposed corporate structures resulting from the transaction may impact the quality of telephone service provided in New York. Thus, we examined the reactions of the major credit rating agencies, Moody's Investors Service (Moody's) and Standard & Poor's (S&P).

On February 14, 2005, Moody's placed the long- and short-term ratings of Verizon Communications, Inc. and the long-term ratings of Verizon's telephone subsidiaries' on review for possible downgrade based upon Verizon's plan to acquire MCI.[151] On May 20, 2005, Moody's downgraded the ratings of six of the operating companies as part of its review and

[150] See FASB Statement No. 142, Goodwill and Other Intangible Assets (issued June 20001).

[151] Moody's Global Credit Research Action, Moody's Places Verizon's Ratings (Parent at A2, Prime -1) on Review for Possible Upgrade (dated February 14, 2005).

noted that the ratings of the parent as well as all of the operating companies' ratings remained on review for possible downgrade, pending the resolution of its assessment of Verizon's bid for MCI.[152] To date, S&P has not initiated any action as a result of the proposed merger.

On April 20, 2004, Moody's downgraded Verizon NY's senior unsecured securities to "Baa2" from "A2," the lowest rating among all rated Verizon affiliates, and only two notches above a non-investment grade rating.[153] The ratings of the other 17 rated affiliates range from "Aa3" to "A3," and Verizon's corporate rating is "A2." S&P does not differentiate between affiliates, and all affiliates are rated the same as the parent's "A+" rating.

Before Verizon's initial bid for MCI, on December 6, 2004, Moody's affirmed Verizon NY's "Baa2" rating and accorded it a stable outlook.[154] Moody's acknowledged the steps VNY had taken to improve its financial status including eliminating the upstream dividends that it had previously paid to the parent corporation and Verizon NY's continuing effort to substitute external debt with intra-company debt. As noted above however, the debt ratings for the parent corporation and all of Verizon's subsidiaries with independent ILEC operations are currently under review for a possible downgrade. In its May 20, 2005 release, Moody's cited persistent revenue declines as a result of continuing access line losses and reduced cash flows as a result of Verizon's "expensive, but necessary" Fiber-to-the-Premises network upgrade as the primary reasons for potential downgrades. And with respect to the impact of the MCI merger, Moody's indicates that Verizon's ratings are subject to substantial execution risk. Specifically, Moody's noted Verizon's indication that it expects the net present value of synergies from the deal to be about $7 billion, and that it will require somewhere between $3 and $3.5 billion over the next three years to achieve these savings. If, in Moody's view, these synergies require additional investment or take longer to materialize than expected, downgrades could follow.[155]

Our review of the merger's financial implications also considered Verizon's view that the greatest threat facing Verizon today is the competitive threat posed by cable competitors and

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[152] Moody's, Global Credit Research Rating Action, Moody's Downgrades Certain Verizon Subsidiaries (New England, NJ, PA, MD, VA and Southwest): Ratings of all Verizon Subs Remain on Review for Possible Downgrade (dated May 20, 2005).

[153] Moody's, Global Credit Research Rating Action, Moody's Downgrades the A2 Senior Unsecured Debt Ratings of Verizon New York to Baa2 (dated April 20, 2004).

[154] Moody's, Global Credit Research Rating Action, Moody's Changes Ratings, Outlooks of Some Verizon Subsidiaries; Affirms Parent, Verizon Communications; Reviews or Affirms Other Subs (dated December 6, 2004).

[155] Moody's Investors Service, Global Credit Research Rating Action, (dated May 20, 2005).

VoIP. In this context, the merger appears to be a reasonable competitive response. Thus, we believe Verizon's decision to upgrade its networks, enhance and diversify its revenue streams through long distance, broadband, wireless and video service offerings, and accelerate the development of its enterprise data services business as reasonable in strategic terms. From an operational standpoint, it appears that the MCI acquisition will firmly establish the company as the number two provider in enterprise data services. We also note that acquiring MCI's extensive long distance network should enable Verizon to reduce its long distance, broadband and wireless long haul transport costs. Finally, as elaborated above, there appears to be a potential for substantial synergy savings as a result of the merger.

As indicated above, however, due to Verizon's current organizational structure most of the financial benefits from the various growth initiatives (e.g. broadband and wireless) do not accrue directly to Verizon's ILEC operations. In other words, the Verizon subsidiaries with ILEC operations, like VNY, only benefit indirectly to the extent that the non-regulated activities bolster the parent company's overall credit rating. Given Verizon NY's heavy reliance on intra-company debt, it is the parent's rating that is critical to New York's telecommunications customers and thus of greater concern to the Commission.

The Committee on Corporations, Authorities & Commissions urges the Commission to determine to what extent any lingering liabilities caused by the financial difficulties that MCI has suffered over the past three to five years will affect Verizon's ability to provide adequate telephone service at just and reasonable rates. Given Verizon's previous inability to provide adequate service uniformly across New York State in recent years, the Committee on Corporations, Authorities & Commissions recommends that the Commission work with Verizon to create strategies that will guard against any additional deterioration of telephone service arising from the merger.[156]

Verizon contends such scrutiny is not needed here because MCI's financial problems have been scrutinized by many courts and agencies. Verizon also claims that if liabilities remain, they will not affect Verizon's New York service quality. Staff's analysis, however, found statements made by Verizon that indicate that it may be premature to conclude that all of MCI's financial problems have been resolved and that there is no need for further concern.

[156] Committee on Corporations, Authorities & Commissions Comments, page 9.

In one of its filings with the SEC, Verizon referred to a consultant's report that had found MCI did not maintain effective internal control over financial reporting as of December 31, 2004.[157] Specifically, the consultant found a material weakness related to MCI's internal control over accounting for income taxes due to a lack of personnel with adequate expertise in income tax accounting matters, a lack of documentation, insufficient historical analysis and ineffective reconciliation procedures. As a result, the consultant concluded there is more than a remote likelihood that a material misstatement in MCI's annual or interim financial statements, due to errors in accounting for income taxes, could occur and not be prevented or detected by MCI's internal control over financial reporting.

In response to a Staff information request, Verizon stated that it considered this matter when negotiating the terms of the acquisition. Verizon noted that as a result of the report, MCI had applied other procedures to improve the reliability of its accounting for income taxes and that MCI management felt their financial statements were fairly stated in all material respects. Verizon also noted that MCI had initiated significant remediation activities to address the identified weaknesses, and that Verizon was conservative when formulating assumptions relating to income taxes when evaluating and negotiating the terms of the transaction. Lastly, Verizon notes the Merger Agreement includes a purchase price adjustment relating to tax claims exceeding a certain agreed-upon dollar amount.[158]

Staff specifically requested that Verizon provide all internal Verizon documents discussing the consultant's report and what it means to Verizon as a potential acquirer. However, all Verizon provided were the above unsupported statements. While service quality is addressed in part V(b) of this document, we recommend the Commission condition the merger on Verizon taking steps to ensure that Verizon's New York intrastate operations are not affected by any MCI accounting and financial improprieties discovered after the transaction is approved by the Commission.

Financial Issues – Staff's Conclusions

We seek comment on Staff's tentative conclusions related to the financial issues of the merger:

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[157] Verizon's June 2, 2005, Form S-4, pages 141- 142.

[158] Response to VZ34.

1) No basis exists at this time for initiating a rate proceeding or requiring that Verizon pass along savings and revenue enhancements related to synergies expected to result from the transaction.
2) The acquisition of MCI is not expected to impair Verizon's ability to attract the capital necessary to upgrade Verizon's wireline infrastructure in New York. However, Verizon's securities could be downgraded, resulting in higher capital costs for Verizon's New York regulated operations.
3) From a financial perspective, the acquisition appears to be a reasonable competitive response and strategy to growing intermodal competition.

Financial Issues – Remedies

We seek comment on Staff's proposed financial remedies:

1) Verizon's New York utility customers should be insulated from costs that result from the merger, including the amortization expenses resulting from the write-up of intangible assets recorded as a result of the transaction, and any charges to earnings for the write-off goodwill recorded by Verizon as a result of the acquisition.
2) None of the additional equity resulting from recording the transaction under the purchase method of accounting should be considered in any derivation of Verizon's New York intrastate ROE.
3) The Commission should condition its approval of the transaction on requiring that Verizon take steps to ensure that Verizon's New York intrastate operations are not impacted as a result of any MCI accounting or other improprieties.

VII. SBC/AT&T Merger Analysis

Overview of Companies

SBC provides a full range of voice, data, and Internet services for residential and business customers, mostly in a 13-state region. SBC serves 52.4 million access lines and has 5.1 million DSL lines in service nationwide. SBC holds a 60% economic and 50% voting interest in Cingular Wireless, which serves 49.1 million wireless customers.[159] SBC's retail

[159] SBC/AT&T Merger Petition, page 2. It is noted that over the past several years, SBC has completed several acquisitions to establish itself as a national provider: Pacific Telesis Group (1997); Southern New England Telecommunications (1998); and Ameritech (1999).

wireline revenues are about split between business services and consumer services.[160] SBC has approximately 1,400 access lines in New York State.[161]

AT&T operates the world's largest communications network and maintains a presence in more than 50 countries across the globe. AT&T also offers national and global Internet Protocal (IP)–based networks, an unmatched portfolio of data and IP services, hosting, security and professional services, technology leadership through its AT&T Labs, skilled networking capabilities, and a highly significant base of government and large enterprise customers.[162] AT&T and its subsidiaries[163] have approximately 375,000 facilities-based access lines in New York State. [164] Business services account for about 74% of AT&T's revenue.[165]

Rationale for SBC/AT&T Merger

Petitioners' rationale for the merger is similar to that provided in the Verizon/MCI merger petition. The SBC/AT&T petition suggests that "the merger will enhance the abilities of the operating subsidiaries to offer a broad array of existing and emerging telecommunications services by bringing together two telephone companies with complementary strengths and by capitalizing on the synergies related to the companies' shared values of customer service, innovation and reliability."

According to SBC and AT&T, the merger provides an ideal opportunity for both companies in light of current intermodal competition and the historical division of local and long distance markets. After the 1984 divestiture:

> *. . . companies on both sides of the divide were long precluded from taking advantage of the enormous efficiencies associated with operating an end-to-end network. But the broadband future of our country critically depends on the ability*

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[160] FCC Docket No. 05-65, Merger of SBC Communications Inc. and AT&T Corporation, Description of the Transaction, Public Interest Showing, and Related Demonstrations (SBC/AT&T FCC Application), filed February 21, 2005, Carlton & Sider Decl. ¶ 14.

[161] The source of this information is data filed by carriers as required by 16 NYCRR 603 and represents facility lines only. It is also noted that data provided for Verizon's March 2005 final PAP report shows SBC had a small number of UNE-Loops lines and Total Service Resale lines in service during that month.

[162] SBC/AT&T Merger Petition, page 3.

[163] The AT&T subsidiaries operating in New York are AT&T Communications of New York, Teleport Communications Group, Inc., TC Systems, Inc., Teleport Communications New York , Inc., and ACC National Telecom Corp., SBC/AT&T Merger Petition, pages 4-5.

[164] The source of this information is data filed by carriers as required by 16 NYCRR 603.

[165] SBC/AT&T FCC Application, Carlton & Sider Decl. ¶ 8.

> *of companies to assemble these separate networks. The maximum potential of broadband can only be achieved where broadband capabilities are implemented at all levels of the network.* [166]

According to AT&T, in June 2004 it was faced with a strategic dilemma. As a result of competition from the RBOCs (that had won the right to offer long distance services) and the growth of wireless alternatives, it "quickly became obvious that AT&T could remain an active competitor in the residential and small business markets only if it could find a viable and profitable means of augmenting its long-distance offerings with economically viable local service offerings that would allow AT&T to match other wireline and wireless providers' attractive "'all distance" offerings."[167] The company made the decision to stop actively competing in the residential and small business markets, and to allow its mass market customer base to decline over time; from June 2004 to December 2004, AT&T lost almost 500,000 customers nationwide.[168]

SBC views the merger as a means to gain access to AT&T's valuable national and global enterprise customers.[169] The company operates a dense local network in 13 states and has limited out-of-region and long distance assets,[170] and much like Verizon's view of MCI, SBC concludes that access to AT&T's customers, facilities and research elements will complement its existing, primarily local exchange services. SBC estimates the transaction will result in annual cost savings of almost $2 billion beginning in 2008.[171] The Petitioners note specifically that the merger does not call for any change in the rates, terms or conditions for the provision of any telecommunications services provided in New York.[172]

Parties' Comments - General

Five parties commented on the SBC/AT&T merger. The Consumer Federation of America (CFA) noted that:

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[166] Id., Executive Summary, page iii.

[167] Id., Polumbo Decl. ¶ 6.

[168] Id., Polumbo Decl., ¶ 35.

[169] SBC/AT&T FCC Application, page 7.

[170] Id., Carlton & Sider Decl. ¶ 31.

[171] Id., page 23.

[172] SBC/AT&T FCC Application, page 6.

> *There is no dispute that the FCC's recent Triennial Review Order….drove AT&T, MCI and others from serving the residential mass market through the UNE-P platform, but they were migrating to other technologies*[173]

> and

> *AT&T became an aggressive player in the VoIP market. AT&T set a goal of winning 1 million business and residential customers by the end of 2005 and provided a competitive VoIP offering (CallVantage).*[174]

AT&T disputes this, saying while it does offer CallVantage to new customers, AT&T has substantially reduced investment in the marketing of CallVantage. AT&T also notes it has terminated most of its outside telemarketing vendors and reduced headcount in its consumer operations. AT&T also asserts that it no longer markets traditional local/long-distance bundles or stand-alone long distance services, nor does it attempt regain customers previously lost to competitors ("win-backs)."[175]

Comments were submitted in the New York proceeding by Conversent, Qwest, Level 3, US LEC, and the Rural Independents. The major concern expressed by these comments is that there is an opportunity for SBC and Verizon to engage in "tacit collusion." Specifically, the combined SBC/AT&T would purposefully, but not in writing, decide not to compete in New York with the combined Verizon/MCI, who would in turn purposely, but not in writing, not compete with SBC/AT&T where SBC has significant ILEC operations. Both SBC and Verizon characterize these concerns as "unfounded."

In their reply comments, SBC and AT&T state that the merger will benefit competition in New York since the combined company intends to compete for customers and that there is no tacit agreement between SBC and Verizon not to compete with one another. Petitioners maintain that the purpose of the merger is to position the combined firm to compete more effectively.

Mass Market – SBC/AT&T

AT&T currently has a significant market share in New York's mass market. The AT&T market presence does not matter in a merger analysis if its partner, SBC, does not have a significant market share. As SBC has less than 10,000 lines in New York, SBC did not provide

[173] Comments of CFA, page 6.

[174] Id., page 7.

[175] SBC/AT&T FCC Application, page 25.

data to the FCC for its CLEC operations in New York. The merger of SBC and AT&T would appear to have a negligible effect on market concentration in New York. Thus, there does not appear to be a need for a remedy for New York mass market customers as a result of this merger.

Enterprise Market - SBC/AT&T

The SBC and AT&T merger may impact concentration of the large enterprise business market when one defines it as a nationwide market. For the State of New York, however, SBC's small market share makes the merger one that does not increase market concentration in the New York market.

Wholesale Transport Market – SBC/AT&T

Although AT&T has a competitively significant share of the transport market in New York, the SBC share is negligible. Thus, the impact of the merger of SBC and AT&T on market concentration is insignificant.

Wholesale Special Access/High Capacity Loop Market – SBC/AT&T

AT&T is a significant player in the wholesale special access and high capacity loop markets in New York. Staff is still investigating SBC's role in the New York market, including accumulating data collected to determine SBC's share of the retail special access market.[176] If SBC's market share is very small, the impact of the SBC/AT&T merger on the competitiveness of this market would be insignificant.

Service Quality

The Commission's service quality reporting requirements for competitive carriers that serve fewer than 500,000 access lines is not as extensive as it is for Verizon. Further, to the extent a competitive carrier is providing service through total service resale or UNE-P, the requirements may be further reduced. In general, service quality performance filings are required of all facilities-based local exchange carriers on a monthly basis unless the company earns a commendation (then required quarterly). The standards required under 16 NYCRR 603.3, Metrics and Performance Thresholds, addresses maintenance service, installations, network performance and the answer time that each service provider is expected to meet or exceed.

[176] According to information provided to Staff, SBC does not provide wholesale local access services in New York.

In 1988, the Commission established a commendation process to recognize local exchange carriers that provide exemplary service quality. Commendations are based on two metrics: the Customer Trouble Report Rate (CTRR) and the PSC Complaint Rate. The following are the results for 2004 for SBC and AT&T:

Table 12 – Commission Commendations for Exemplary Service Quality

Recent Performance For SBC and AT&T			
Company	**CTRR**	**PSC Complaint Rate**	**Number of Consecutive Years Receiving Commendation**
SBC	100%	0	First
AT&T	100%	0	Second

As illustrated, both SBC and AT&T have recently received Commission commendations, and their overall service quality has been meeting, or exceeding, service quality standards.[177]

Retail Service Quality – Staff's Conclusions

AT&T currently measures and reports retail service quality performance data in New York by operating entity. AT&T and SBC have stated that they plan to continue to measure and report retail service performance data by operating entity until or unless these are consolidated.[178] Staff has not identified any major concerns associated with retail service quality, and no remedies appear to be needed. .

Wholesale Service Quality – Staff's Conclusions and Remedies

Most of the parties suggested that neither this merger, nor the MCI/Verizon merger should be considered in a vacuum; that AT&T and MCI represent the biggest competitors to Verizon for the provision of resale or wholesale services, such as local loop and transport facilities (special access facilities) which smaller carriers then use to serve end-user customers, and that, behind Verizon, AT&T and MCI have each constructed loop facilities to more buildings than any other non-local exchange carrier.

In addition, the parties contend that the merger eliminates a powerful, wealthy and effective voice in pushing competitive issues at the state and federal levels. With AT&T (and

[177] Staff notes that AT&T's answer time performance has been below standards (80% answered within 30 seconds) for over a year.

[178] Response to SBC23.

MCI) no longer filling that capacity, smaller carriers will have greatly diminished leverage and bargaining power against Verizon. According to the comments, the combined post-merger scenario could also:

- create disincentives for small carriers by favoring merged affiliates;
- provide a powerful incentive for SBC and Verizon to engage in "tacit collusion" by not competing in each other's territories; and
- remove discounted rate structures that AT&T provided to smaller carriers for wholesale services as an alternative to Verizon.

Staff tentatively concludes the concerns raised by the parties are not significantly affected by a merger between AT&T, a carrier with a significant presence in New York, and SBC, a carrier that does not have a significant New York market presence. AT&T is a significant competitor in both the pre-merger and post merger scenarios. As such, no remedies are proposed; Staff seeks comments on this conclusion.

Financial Issues

As SBC and AT&T operate as CLECs in the New York retail market, Staff's interests in the impact of the acquisition of AT&T on SBC's financial situation is much less than its concern about the impact on Verizon's New York operations of Verizon's acquisition of MCI. For example, SBC and AT&T project synergies savings from their merger but since the Commission only lightly regulates these companies from a financial and rate perspective, there is no need to examine the projected synergies in any depth. However, Staff did review the financial aspects of the proposed merger of SBC and AT&T focusing on the reactions of the major credit rating agencies with an interest in assuring the long-term health of the New York telecommunications market. The companies' petition notes that "SBC expects capital spending totaling approximately $2 billion (before synergies), which is (said to be) considerably higher than the total amount AT&T and SBC would likely spend absent the merger."[179]

On January 31, 2005, Moody's placed SBC and its ILEC subsidiaries' "A2" long term debt rating on review for possible downgrade based on the company's plan to acquire AT&T.[180]

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[179] SBC/AT&T Merger Petition, page 9.

[180] Moody's Global Credit Research Rating Action, Moody's Places SBC's Ratings on Review for Possible Downgrade and AT&T's LT Rating on Review for Possible Upgrade (dated January 31, 2005).

At the same time, it placed the "Ba1" long term debt rating of AT&T on review for possible upgrade. On October 21, 2004, Moody's had downgraded SBC's long term debt from "A1" as a result of its 60%-owned Cingular's acquisition of AT&T Wireless.[181] In its February 25, 2005 review, Moody's noted that SBC's purchase of AT&T will establish it as the leader in enterprise data services, and that ownership of AT&T's long distance network will enable it to stabilize its cost structure in relation to its own consumer long distance, broadband and even wireless long haul transport needs.[182] Moody's also, however, has concerns that may likely result in the near term capital costs of the company being somewhat higher but Staff tentatively concludes that there is no basis for recommending the Commission reject the proposed transaction or imposing remedies at this time.

Staff's Conclusion

Staff finds SBC and AT&T's rationale to merge is similar to that provided in the Verizon/MCI merger petition. SBC/AT&T note the merger does not call for any change in the rates, terms or conditions for the provision of any telecommunications services provided in New York. Staff concludes that given the relatively few access lines SBC has New York, it appears this merger should have no anticompetitive effect on New York's telecommunications markets. Thus, Staff does not offer a remedy, but does note that market concentration resulting from this merger may be problematic on a national basis.

Both SBC and AT&T have recently received Commission commendations, and overall service quality has been meeting, or exceeding, service quality standards. AT&T currently measures and reports retail service quality performance data in New York by operating entity. AT&T and SBC have stated that they plan to continue to measure and report retail service performance data by operating entity until or unless these are consolidated. As Staff has not identified any major concerns associated with retail service quality, no remedies appear to be needed. Parties' concerns with Internet-based services are deemed more appropriately addressed at the national level.

[181] Moody's Global Credit Research Rating Action, Moody's Lowers Long Term Debt Ratings of SBC and BellSouth to A2, and Cingular to Baa2; Confirms Baa2 Long Term Debt Rating of AT&T Wireless; Outlooks for SBC and BellSouth are Negative; Outlooks fort Cingular and AT&T Wireless are Stable (dated October 26, 2004).

[182] Moody's Global Credit Research Rating Action, Moody's Places SBC's Ratings on Review for Possible Downgrade and AT&T's LT rating on Review for Possible Upgrade (dated January 31, 2005).

As SBC and AT&T operate as CLECs in the New York retail market, Staff's interests in the impact of the acquisition of AT&T on SBC's financial situation is much less than its concern about the impact on Verizon's New York operations of Verizon's acquisition of MCI in light of the fact that both are only lightly regulated in New York. With the Commission's lightened regulation of these companies, there does not appear to be a reason to be concerned about synergies, or increased costs resulting from the merger.