ATTACHMENT 4

In the Matter of Special Access Rates for Price Cap Local Exchange Carriers	**WC Docket No. 05-25**

Declaration

of

SUSAN M. GATELY

on behalf of

Ad Hoc Telecommunications Users Committee

June 13, 2005

DECLARATION OF SUSAN M. GATELY

EXECUTIVE SUMMARY

In August, 2004 the Ad Hoc Telecommunications Users Committee ("Ad Hoc") released *Competition in Access Markets: Reality or Illusion - A Proposal for Regulating Uncertain Markets* (herein after "*Reality or Illusion*"). The paper was prepared under my direction. *Reality or Illusion* debunked the popular illusion of readily available competitive alternatives for local access facilities, particularly the kinds of dedicated access facilities (*aka* special access) that large enterprise customers utilize. In conjunction with its review of the issues raised by the instant NPRM, the Ad Hoc Committee asked that I review and update the material in that paper with any new data that may have become available since that time. This declaration contains the results of that effort. Refreshing the data with year-end 2004 results, and including RBOC data submissions that were made after the original work was complete only reinforced the conclusions drawn in the initial analysis. The new data shows that RBOC rates of return on special access services are higher than ever (53.7% average across the four RBOCs), that intermodal competitive offerings still do not address the needs of enterprise customers, and that at the vast majority of commercial locations nationwide, enterprise customers have nowhere to turn but their local RBOC for special access connections.

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Attachments

1 Statement of Qualifications

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of Special Access Rates for Price Cap Local Exchange Carriers	**WC Docket No. 05-25**

DECLARATION OF SUSAN M. GATELY

INTRODUCTION

Susan M. Gately, of lawful age, declares and says as follows:

1. My name is Susan M. Gately; I am Senior Vice President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108. ETI is a research and consulting firm specializing in telecommunications and public utility regulation and public policy. I have participated in numerous proceedings before the Federal Communications Commission ("FCC" or "Commission") dating back to 1981 and have appeared as an expert witness in state proceedings before state public utility commissions. My Statement of Qualifications is annexed hereto as Attachment 1 and is made a part hereof.

2. I have been asked by the Ad Hoc Telecommunications Users Committee ("Ad Hoc") to review and update data contained in a White Paper that was originally prepared under my direction for Ad Hoc in August, 2004. That paper, *Competition in Access Markets: Reality or Illusion - A Proposal for Regulating Uncertain Markets* (hereinafter "*Reality or Illusion*") debunked the popular illusion of readily available competitive alternatives for local access facilities, particularly the kinds of dedicated access facilities (*aka* special access) that large enterprise customers utilize.

UPDATED AND SUPPLEMENTED DATA

3. The Ad Hoc Committee's stated goal in having Economics and Technology, Inc. undertake preparation of the *Reality or Illusion* paper was to cause an examination of the current state of the access services market and the formulation of a plan for a regulatory paradigm capable of affording incumbent local carriers the flexibility they require to meet actual competitive challenges where they exist, while at the same time protecting customers against excessive monopoly prices and practices where the ILEC access services monopoly remains intact.[1] Since the completion of the original paper, new data points have become available allowing me to update many of the analyses with data current through year-end 2004. As described below, in all cases, the newest data reinforces and adds to the strength of the arguments presented in the initial analysis.

4. The August 2004 Ad Hoc paper found that premature deregulation of special access services in advance of the development of a level of competition sufficient to discipline RBOC pricing activities had resulted in a situation such that special access services are today priced significantly in excess of cost. In other words, the *potential* that competitors might deploy services to enterprise customers was not sufficient to constrain RBOC behavior. In fact, based upon year-end 2003 data, we were able to quantify that every day that the FCC allowed to pass

[1] *Competition in Access Markets: Reality or Illusion. A Proposal for Regulating Uncertain Markets*, Economics and Technology, Inc. August, 2004 at ii.

before correcting the regulatory deficiency that allowed pricing flexibility for special access services cost business and government users more than $15-million.[2]

5. Table 1.1 of *Reality or Illusion* documented that based upon year-end 2003 data, excessive special access charges were resulting in overcharges equal to $5.5-Billion in 2003, translating into the $15-million per day overcharge estimate discussed above. Expressed in terms of total interstate access revenues, the overcharges were somewhat less extreme, $3-Billion in 2003 translating into $8.3-Million per day in overcharges.

6. *Updated* Table 1.1, below, documents that the overcharges during 2004 were even more outrageous. Special access rates during calendar year 2004 generated some $6.4-Billion in

***Updated* Table 1.1**

2004 Total RBOC Overcharges
(000)

		Calculation	Total Interstate	Special Access
1	Average Net Investment		$ 28,872,598	$ 9,146,838
2	Net Return		$ 5,745,289	$ 4,912,639
3	ROR	Line 2 / Line 1	19.90%	53.71%
4	Approved ROR	11.25%	11.25%	11.25%
5	Tax Rate	39.25%	39.25%	39.25%
6	Overearnings	(Line 3 - Line 4) * Line 1	$ 2,497,122	$ 3,883,620
7	Overcharging	Line 6 / (1-Line 5)	$ 4,110,488	$ 6,392,790
8	Daily Overcharges	Line 7 / 365	$ 11,262	$ 17,514

Sources: Federal Communications Commission, ARMIS Report 43-04, Access Report: Table I YE 2004. Available at http://www.fcc.gov/wcb/eafs/ (accessed April 25, 2005).
39.25% is the composite tax rate currently used in the FCC's HCPM/HAI Synthesis Cost Proxy Model. http://www.fcc.gov/wcb/tapd/hcpm/welcome.html

[2] *Id.*, at iii and 7 - 8.

excessive special access revenues, $17.5-Million *per day!* This means that the amount by which corporate users of special access services were being *overcharged* in 2004 *increased* by approximately 15% over the already excessive 2003 levels.

7. In a nutshell, using evidence provided by both *RBOC*s and the largest CLEC and CAP *competitors* that do exist, ETI's original research revealed that competitive alternatives simply do not exist at most commercial locations in the United States. Secondarily, RBOC pricing behavior in the special access market corroborates that finding. The RBOCs have been earning excessive, and continually growing, rates of return on special access services, and *prices* for special access services in those areas where they have been granted the pricing flexibility to respond to competition have been *increasing*, not decreasing.

RBOC earnings on special access services have continued to climb.

8. Chapter 3 of the white paper, entitled *Undisciplined Pricing and Limitless Earnings in the Face of Only Putative Competition,* documented that as of the end of 2003 the average rate of return for RBOC special access services averaged a jaw-dropping 43.7%.[3] The results demonstrated that the individual RBOCs were earning multiples of the last FCC authorized rate of return 11.25%, with rates ranging from two times (Verizon at 23.2%) to approximately six times (SBC, Qwest and BellSouth at 63.2%, 68.1% and 69.1% respectively) that 11.25% rate.[4]

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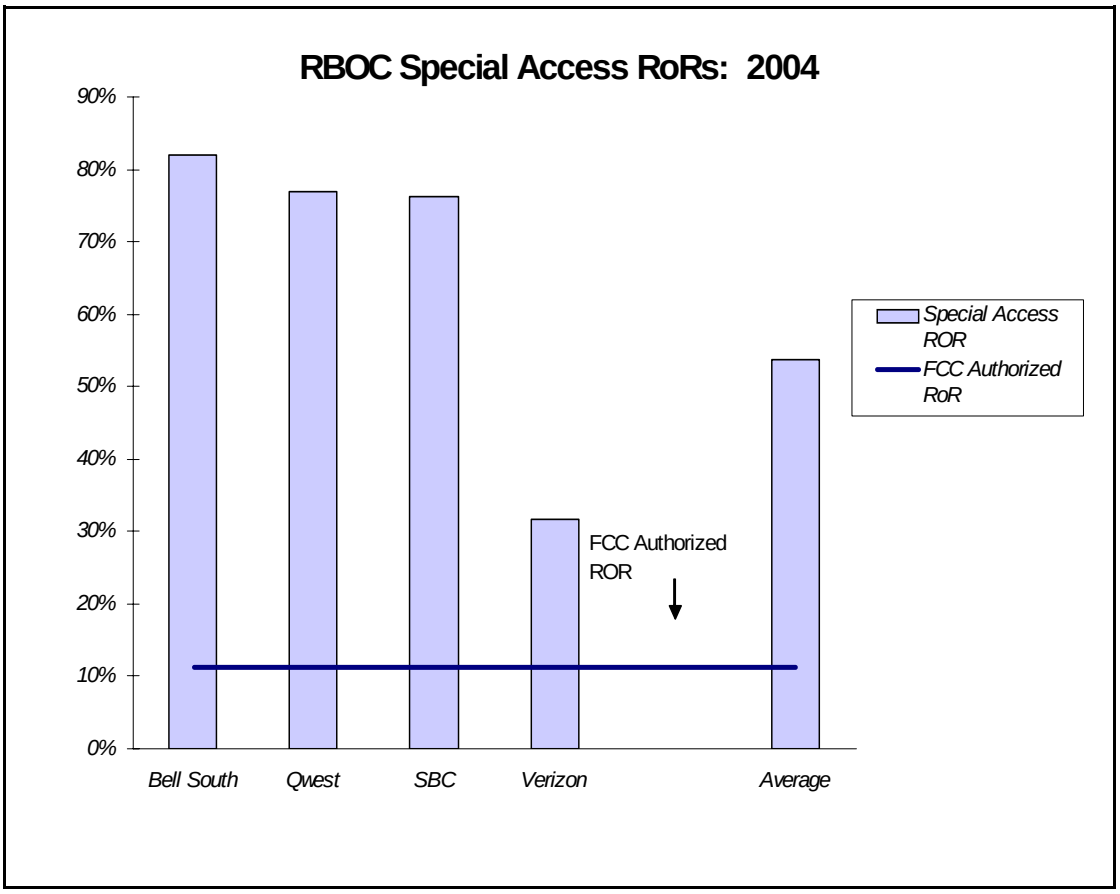
[3] *Id.*, at iv - vi, 28 and 33.

[4] *Id.*, at v -vi, 3 and 28.

9. ARMIS data for the year 2004 shows that the earnings levels on special access service for the most recently ended year are even greater than the jaw-dropping 2003 levels. As of year end 2004, the rates of return on the special access category for the RBOCs were as follows: Verizon - 31.6%, SBC - 76.2%, Qwest - 76.8% and Bell South - 81.9%. The average across all four RBOCs was an awe-inspiring 53.7%. Lest Verizon's 31.6% return level not seem so unreasonable, understand that these return levels are calculated *After* Interest, Taxes, and Depreciation and Amortization adjustments, not before. Wall Street types bandy return levels in this range around from time to time, but those are generally return levels based upon "EBITDA" (Earnings *Before* Interest, Taxes, and Depreciation and Amortization). The Verizon and other LEC return levels are calculated using "Net Return," as reported in ARMIS, and thus largely understate the rates of returns as they would typically be calculated using EBITDA. If we were to recalculate these rate of returns using EBITDA (adding back Depreciation and Amortization, Taxes, and Interest to Net Return) the resulting rates of return would be substantially higher. In this case, using EBITDA methodology, Verizon's rate of return on the special access category would be over 83%.[5]

[5] Federal Communications Commission, ARMIS Report 43-01, Annual Summary Report: Table I, YE 2004. Available at http://www.fcc.gov/wcb/eafs/ (accessed May 23, 2005.) EBITDA is calculated by adding to account 1915 (Net Return) accounts 1180 (Depreciation and Amortization) 1490 (State and Local Taxes) and 1590 (Federal Taxes). This calculation of return is then divided by account 1910 (Average Net Investment).

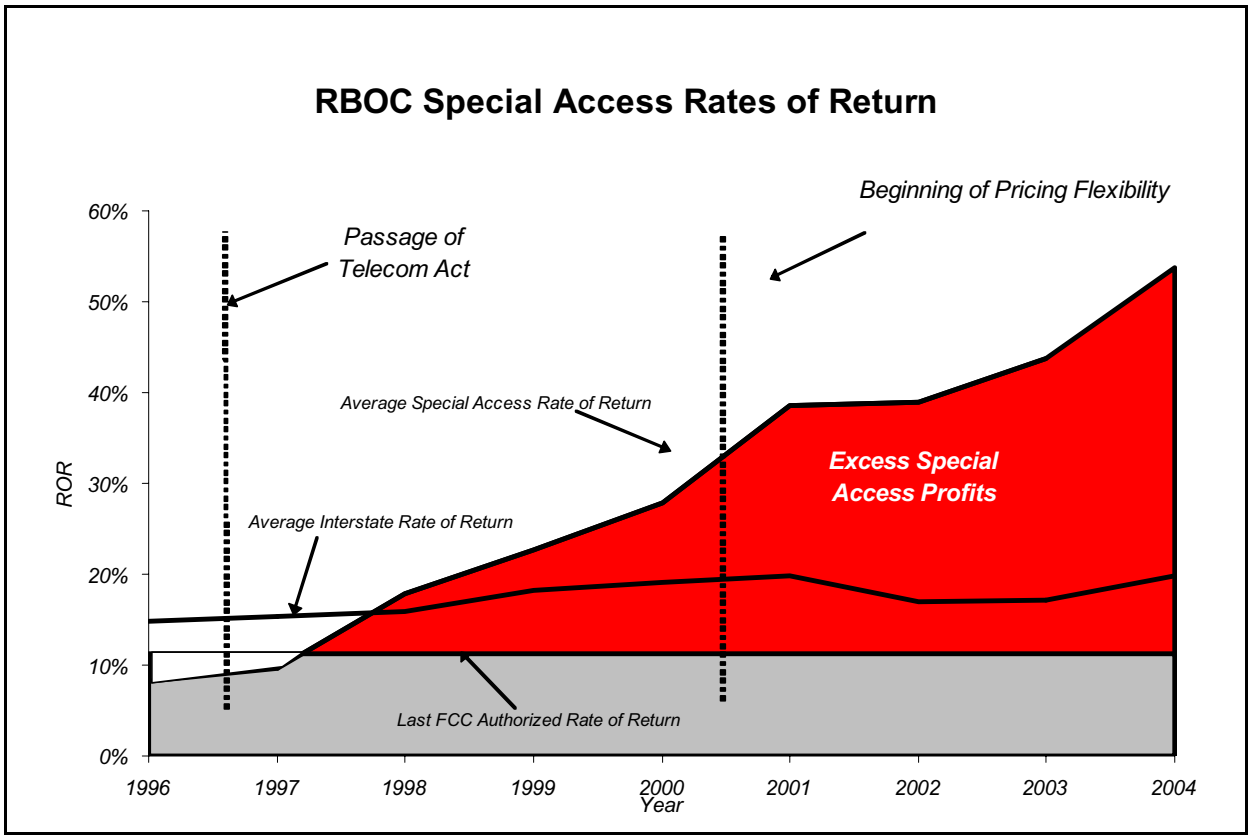


***Updated* Figure 3.1: Analysis of individual RBOC special access rates for return: 2004**

10. Figure 3.1 of *Reality or Illusion* contained a graphic representation of RBOC special access rates of return for 2003.[6] *Updated* Figure 3.1 above contains that same representation using 2004 data, demonstrating that the passage of another year has only exacerbated the problem.

[6] *Id.*, at 28.

11. Figure 3.2 of *Reality or Illusion* contained a graphic representation of the steady increase in RBOC special access rates of return from the time of the passage of the Telecom Act in 1996 to the end of 2003 -- illustrating in particular the excess special access profits generated during that time frame.[7] *Updated* Figure 3.2 below adds 2004 data to that analysis, revealing that the average return level across the RBOCs has continued to climb.



***Updated* Figure 3.2: Average RBOC Special Access realized rates of return. 1996 - 2004**

[7] *Id.*, at 30.

12. Chapter 3 of *Reality or Illusion* also documented that total interstate access return levels were generally substantially above the FCC's last authorized rate. Table 3.1 documented interstate access rates of return for the total interstate category that were, on average, more than 50% above the last authorized return level[8]. Inclusion of 2004 return levels on *Updated* Table 3.1 below demonstrates that, like special access, the overall earnings of the RBOCs have continued to climb, with the *average* interstate rate of return for the RBOCs increasing by 16.4%, from 17.1% to 19.9%. (The new range is between 15.9% earned by Verizon, and 28.7% earned by Qwest.)

***Updated* Table 3.1**

RBOC Interstate Rates of Return

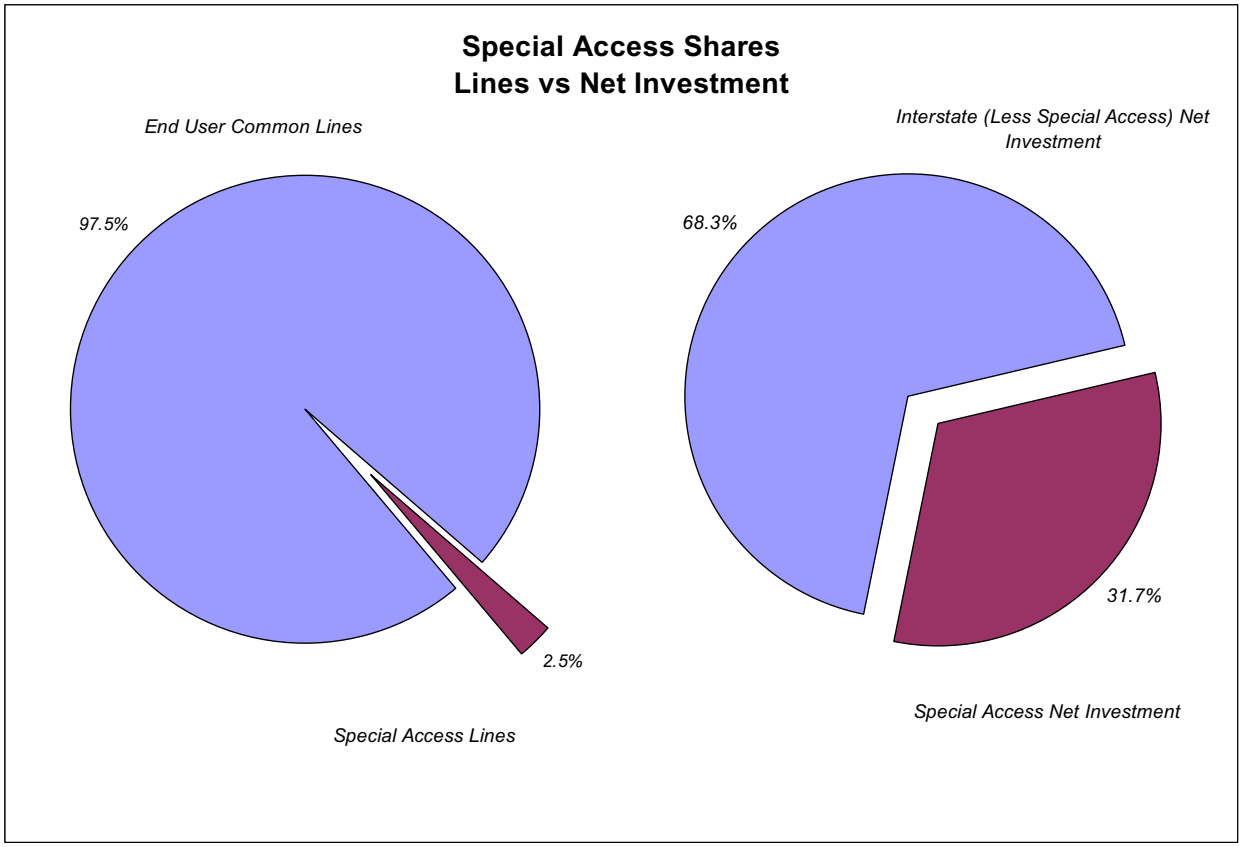
	BellSouth	Qwest	SBC	Verizon	ALL RBOCs
Interstate ROR:2003	19.3%	23.6%	19.8%	12.4%	17.1%
Interstate ROR:2004	20.3%	28.7%	22.2%	15.9%	19.9%

Source: Federal Communications Commission, ARMIS Report 43-04, Access Report: Table I, YE 2003 Access April 7, 2004,& YE 2004 Accessed May 9, 2005. . Available at http://www.fcc.gov/wcb/eafs/

13. Foreshadowing arguments that the costs of special access services have been mis-allocated to other interstate categories, Figure 3.3 of *Reality or Illusion* documented that as of year-end 2003, almost one-third of total interstate investment is found in the special access category even though special access lines accounted for only 2.5% of total RBOC access lines.[9]

[8] Id., at 32. These same return levels were also discussed in the initial report at vi and 7.

[9] *Id.*, at 33-34



***Updated* Figure 3.3: Comparison of Special Access lines shares vs. Special Access net investment shares.**

Analysis of the most recently available ARMIS data reveals those relationship to be much the same as of the end of 2004. *Updated* Figure 3.3, above, documents the results of the same analysis using year-end 2004 data.

14. Following in the same vein, Table 3.2 demonstrated that as of the end of 2004 the net investment allocated to the special access category for the four RBOCs was roughly one third of their total interstate net investment and approximately 40% of their combined Common Line and

Special Access investment categories. With only about 4-million special access loops and associated interoffice transport facilities, compared to more than 158-million Common Line local service loops in the RBOCs' operating territories[10] it appears more likely that the costs of *other* services have been allocated to the special access category rather than vice-versa.[11] *Updated* Table 3.2, below, reveals that conducting the analysis on year-end 2004 data does not change the overall picture revealed by the data..

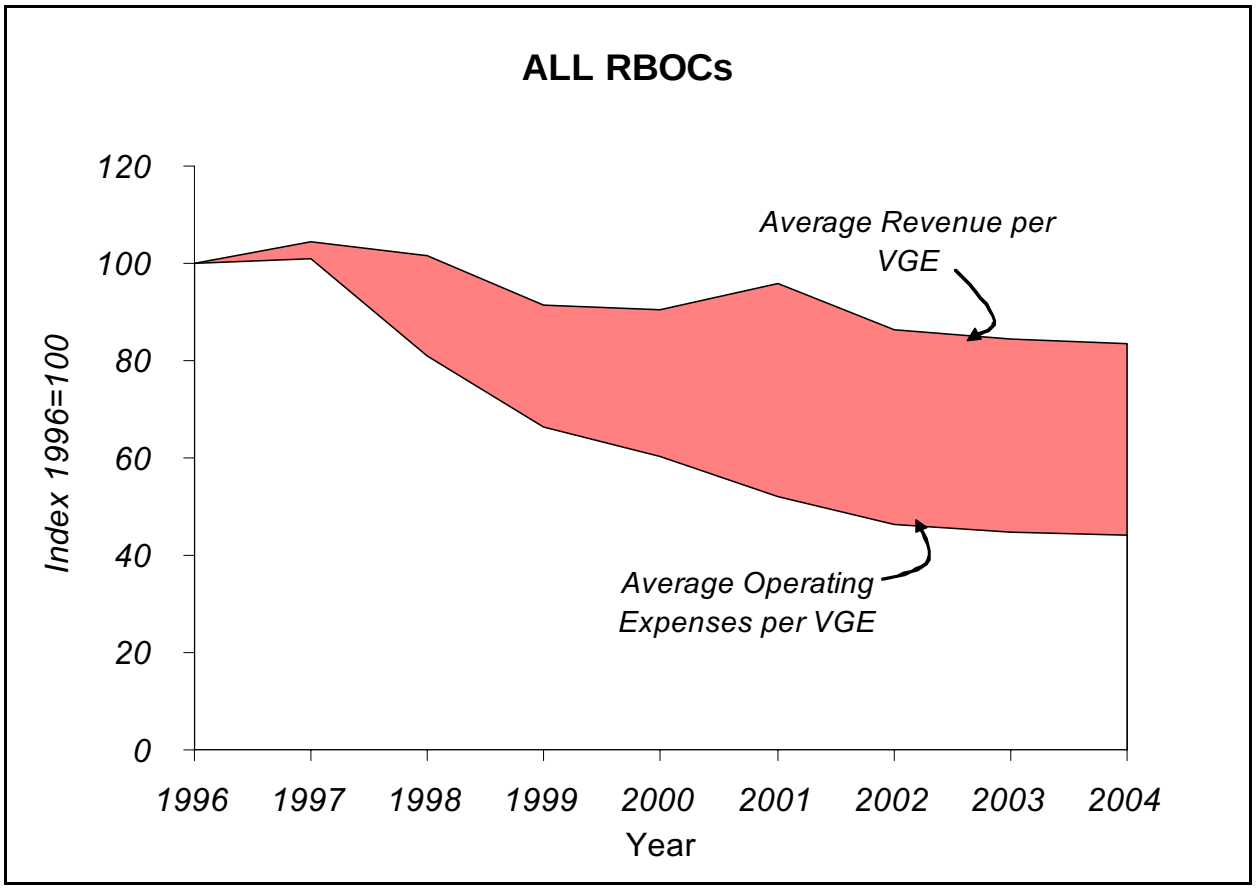
***Updated* Table 3.2**
Analysis of Special Access Net Investments in Relation to Net Investments Levels for All Interstate Access Services – 2004

	BellSouth	Qwest	SBC	Verizon	ALL RBOCs
SPAC Net Investment	$ 1,233,462	$ 884,986	$ 2,241,797	$ 4,786,593	$ 9,146,838
Common Line Net Investment	$ 3,224,118	$ 1,874,363	$ 3,711,745	$ 5,806,389	$ 14,616,615
Total Interstate Net Investment	$ 5,140,361	$ 3,373,090	$ 7,917,404	$ 12,441,743	$ 28,872,598
SPAC as % of Total Interstate Investment	24.0%	26.2%	28.3%	38.5%	31.7%
SPAC as % of SPAC+Common Line Investment	27.7%	32.1%	37.7%	45.2%	38.5%

Source: Federal Communications Commission, ARMIS Report 43-04, Access Report: Table I, YE 2004. Available at http://www.fcc.gov/wcb/eafs/ (accessed April 25, 2005).

[10] While there is no definitive count of Special Access lines, various sources put the count at between 3.2 and 4.5 million lines. A Bellsouth and SBC joint proposal for Assessment and Collection procedures suggests 3.2 million Special Access lines, while data from the FCC's Statistics of Communications Common Carriers puts the value at about 4.5 million. Comments of SBC and Bellsouth, CC Docket Nos. 96-45, 98-171, 90-571, 92-237, 99-200, 96-116, 98-170, 02-33, 95-20, 98-10 and NSD File No. L-00-72, October 10, 2002; Industry Analysis and Technology Division, Federal Communications Commission, *Statistics of Communications Common Carriers 2002/2003*, March 2, 2004 ("*SOCC*") at Table 2.6.

[11] *Reality or Illusion*, at 33-34



***New* Figure 3.4**: **As costs trend downward faster than prices, a widening gap can be seen between the average revenue per special access VGE and the average operating expense per VGE**

15. Supplementing the evidence found in *Reality or Illusion* is *New* Figure 3.4, documenting a widening gap between the operating expenses associated with provisioning a voice-grade equivalent (VGE) of special access services and the average revenue generated by that same VGE, with costs trending down much more quickly than rates.[12]

[12]Federal Communications Commission, ARMIS Report 43-01, Annual Summary Report: Table I, YE 1996-2004, Available at http://www.fcc.gov/wcb/eafs (accessed May 10, 2005).

Competitive metrics continue to demonstrate that competitive alternatives for local access connections are not available to enterprise customers

16. Chapter 2 of *Reality or Illusion*, entitled *No Way Out: The Lack of Alternatives to Special Access*, documents that competitive alternatives are available to connect enterprise customer locations on only a very limited basis, and that RBOCs remain the sole source of dedicated access connectivity at roughly 98% of all business premises nationwide, even for the largest corporate users.[13] The metrics analyzed at that time came from CLECs, the RBOCs, users, and the FCC. The paragraphs below discuss updated data that has become available in several instances since the release of the report. As with the evidence of market behavior discussed above, the new data serves to corroborate the picture painted in the August, 2004 report.

17. Figures 2.1 and 2.2 of *Reality or Illusion*, contained reproductions of two maps prepared and submitted by Verizon documenting that even in what many consider to be the most competitive local service markets in the country - the New York and Washington metropolitan areas, CLECs must rely upon RBOC special access loops to reach enterprise customers.[14] This evidence was submitted in the context of the FCC's Triennial Review Remand Investigation. Shortly after the completion of *Reality or Illusion*, SBC, Bell South and Qwest also made filings with the Commission that revealed the same to be true: in the vast majority of cases, even

[13] *Reality or Illusion*, at 11-26.

[14] *Reality or Illusion*, at 13-15.

CLECs are required to utilize RBOC special access services to reach their (the CLECs) customers.

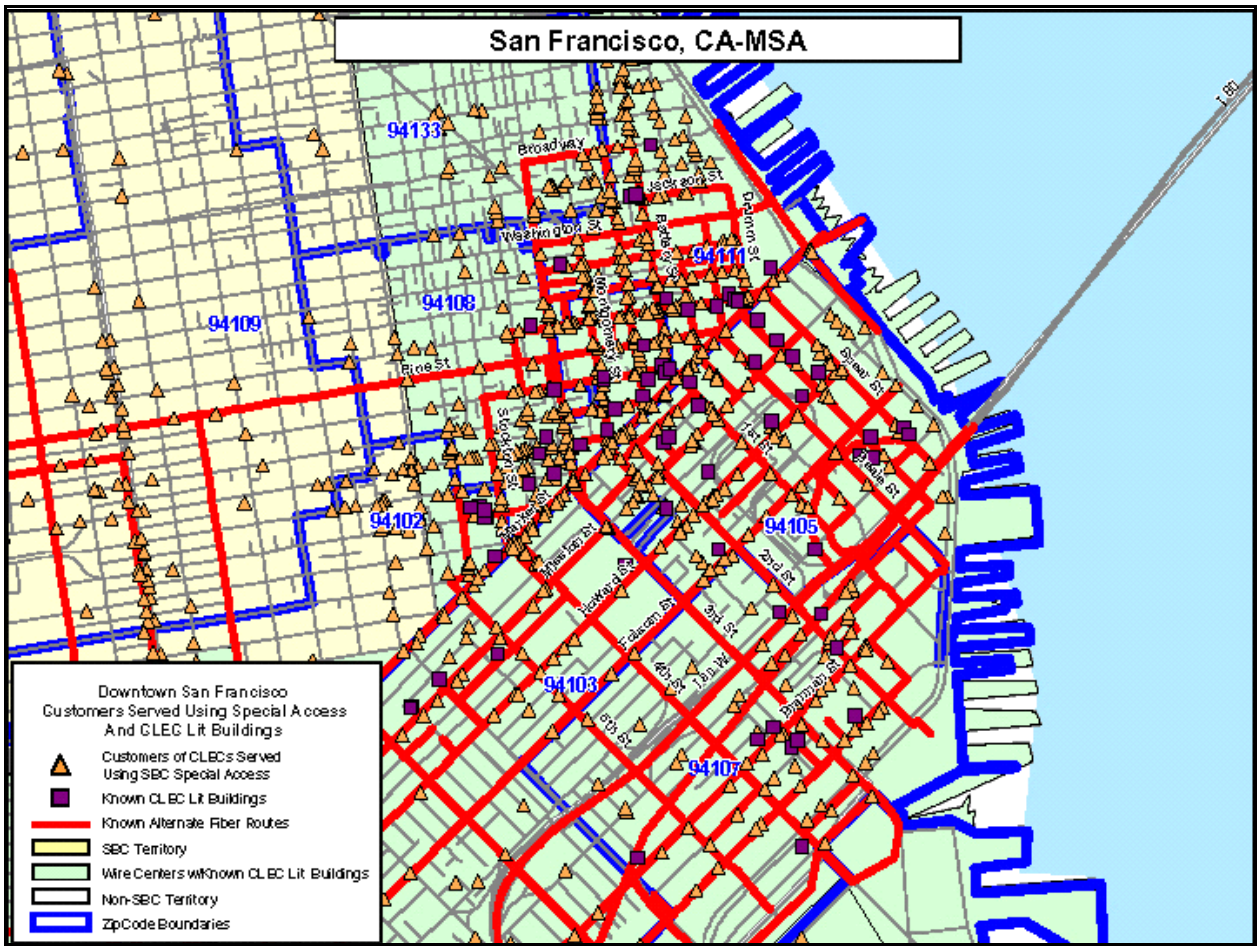
18. Bell South estimated that across its 9 state region only 2,220 buildings can be access via non-ILEC fiber. Compare that to Bell South's estimate that in just one of those states, Florida, it provides approximately 40,000 DS1 special access circuits to CLECs desiring to reach customers in buildings which CLEC-owned fiber is not available.[15] Qwest, providing information to the Commission on the Denver metro area as a surrogate for the rest of its territory reported that CLECs have 979 "lit" buildings in the Denver metro area, and that CLECs purchase 18,563 special access facilities to reach their customers in 6,350 other commercial buildings in the Denver metro area.[16]

19. SBC, in a 94 page *ex parte* filing in that same docket made on August 18, 2004 submitted maps for 22 metro areas.[17] *New* Figures 2.5, 2.6 and 2.7, contain reproductions of

[15]August 18, 2004 *ex parte* filing by Bell South in CC Docket 01-338, *Section 251 Unbundling Obligations for Incumbent Local Exchange Carriers.*

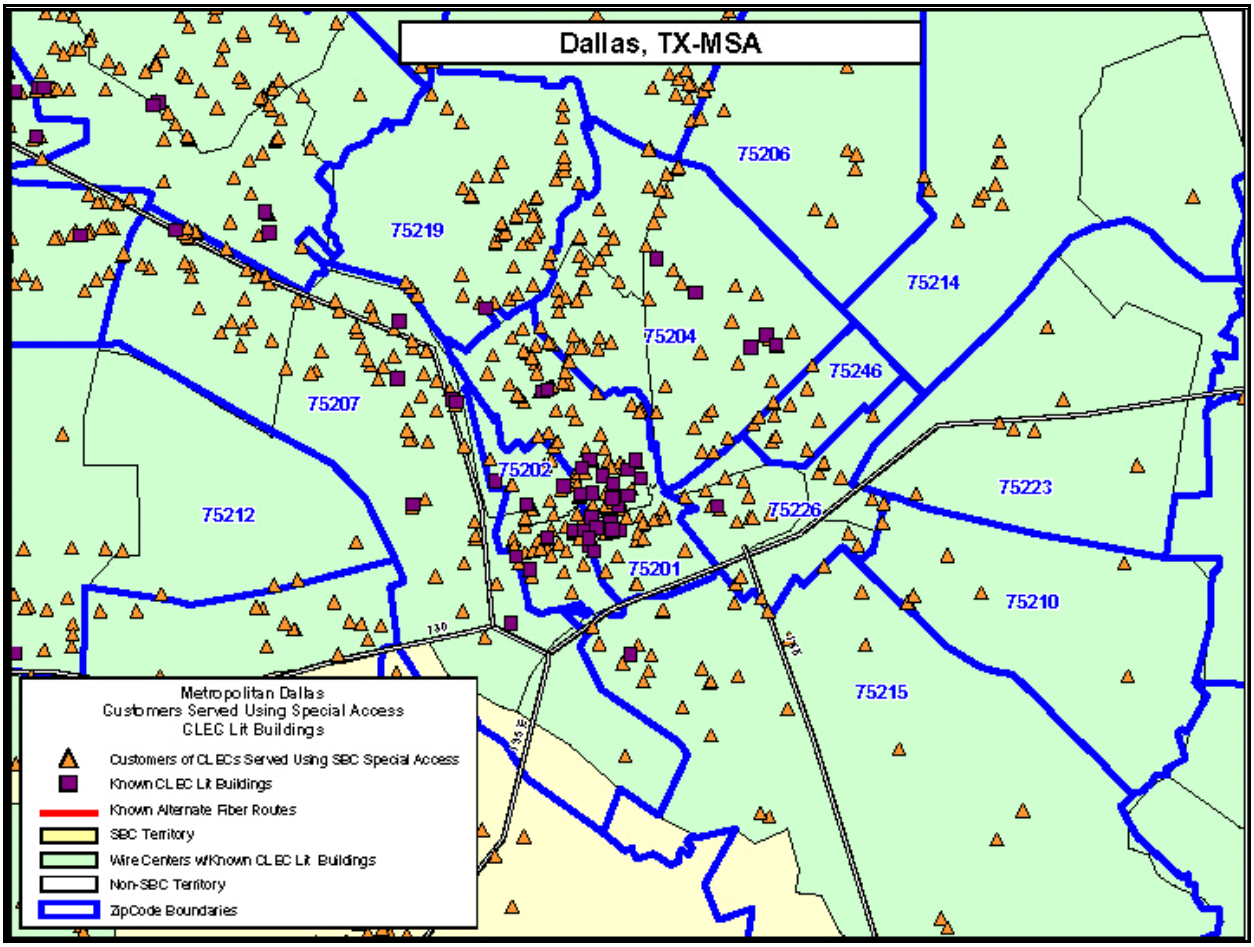
[16]August 20, 2004 *ex parte* filing by Qwest in CC Docket 01-338, *Section 251 Unbundling Obligations for Incumbent Local Exchange Carriers.*

[17]August 18, 2004 *ex parte* filing by SBC Telecommunications, Inc. in CC Docket 01-338, *Section 251 Unbundling Obligations for Incumbent Local Exchange Carriers.*



New* Figure 2.5: Locations of SBC Special Access Services being used by CLECs to provide local service to enterprise customers in the San Francisco metro area *maps supplied by SBC

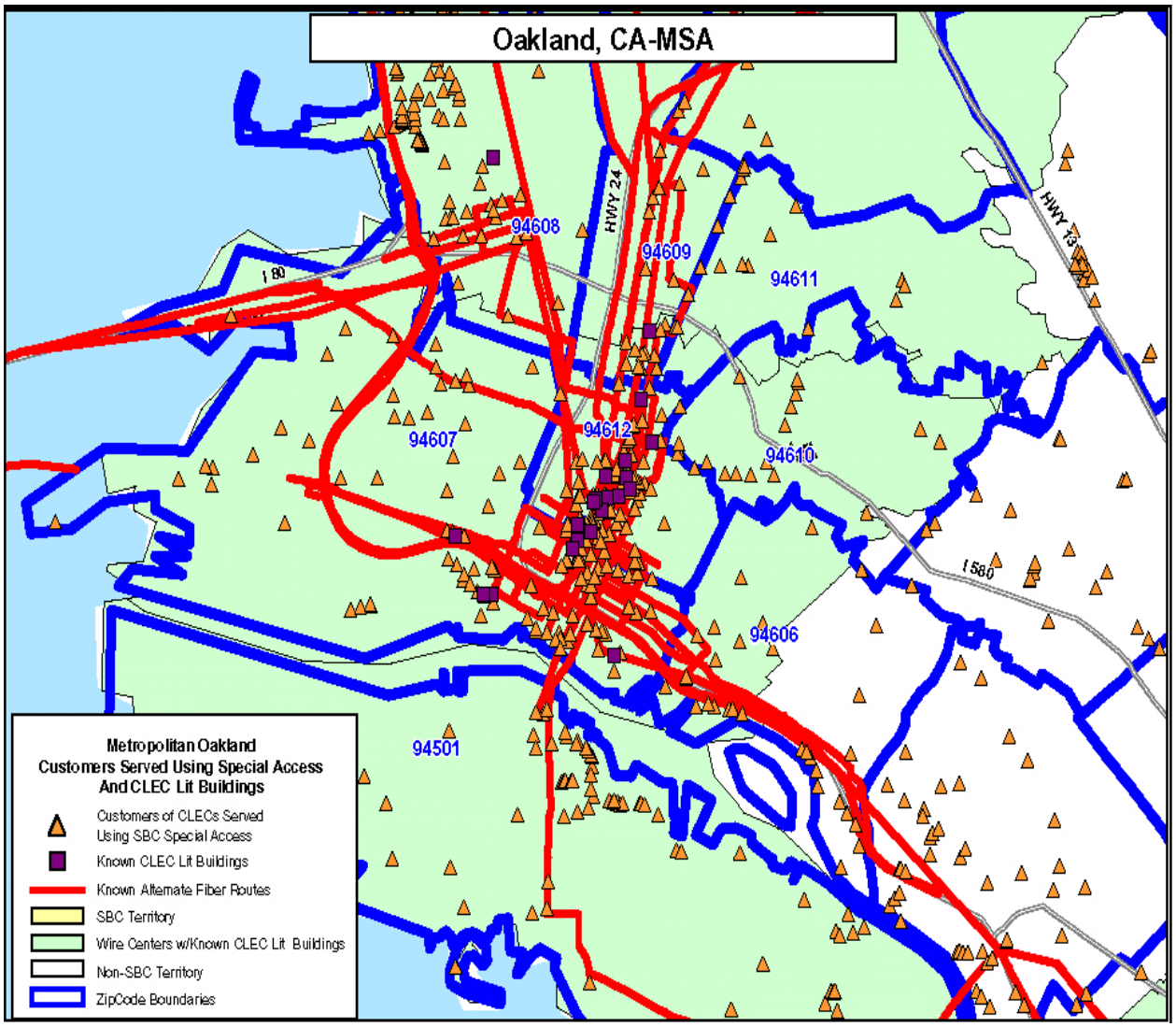
the maps for just three of those areas: San Francisco, Dallas and Oakland. Although a variety of maps were included for each metro area, the maps chosen for inclusion here identify CLEC fiber routes running through the metro areas, CLEC "lit" buildings, and "unlit" buildings where CLECs have customers but need to use SBC special access to reach those customers. The maps clearly document that CLEC "lit" buildings represent only a small portion of the totality of commercial buildings in these metro areas, and that the quantity of buildings where CLECs find it necessary to utilize RBOC special access dwarf the number of buildings the CLECs have



***New* Figure 2.6: Locations of SBC Special Access services being used by CLECs to provide local service to enterprise customers in the Dallas metro areas *map supplied by SBC*.**

actually "lit." Most striking, however, is the fact that in many instances, buildings where the CLECs find it necessary to purchase RBOC special access lie right along CLEC fiber routes!

20. Chapter 2 of *Reality of Illusion* also provided evidence that *intermodal* competitive alternatives (cable, fixed wireless) are not competitive alternatives to high speed special access services. The FCC has since released new data pertinent to portions of those analyses – the new data does nothing to change the competitive landscape detailed previously by Ad Hoc.



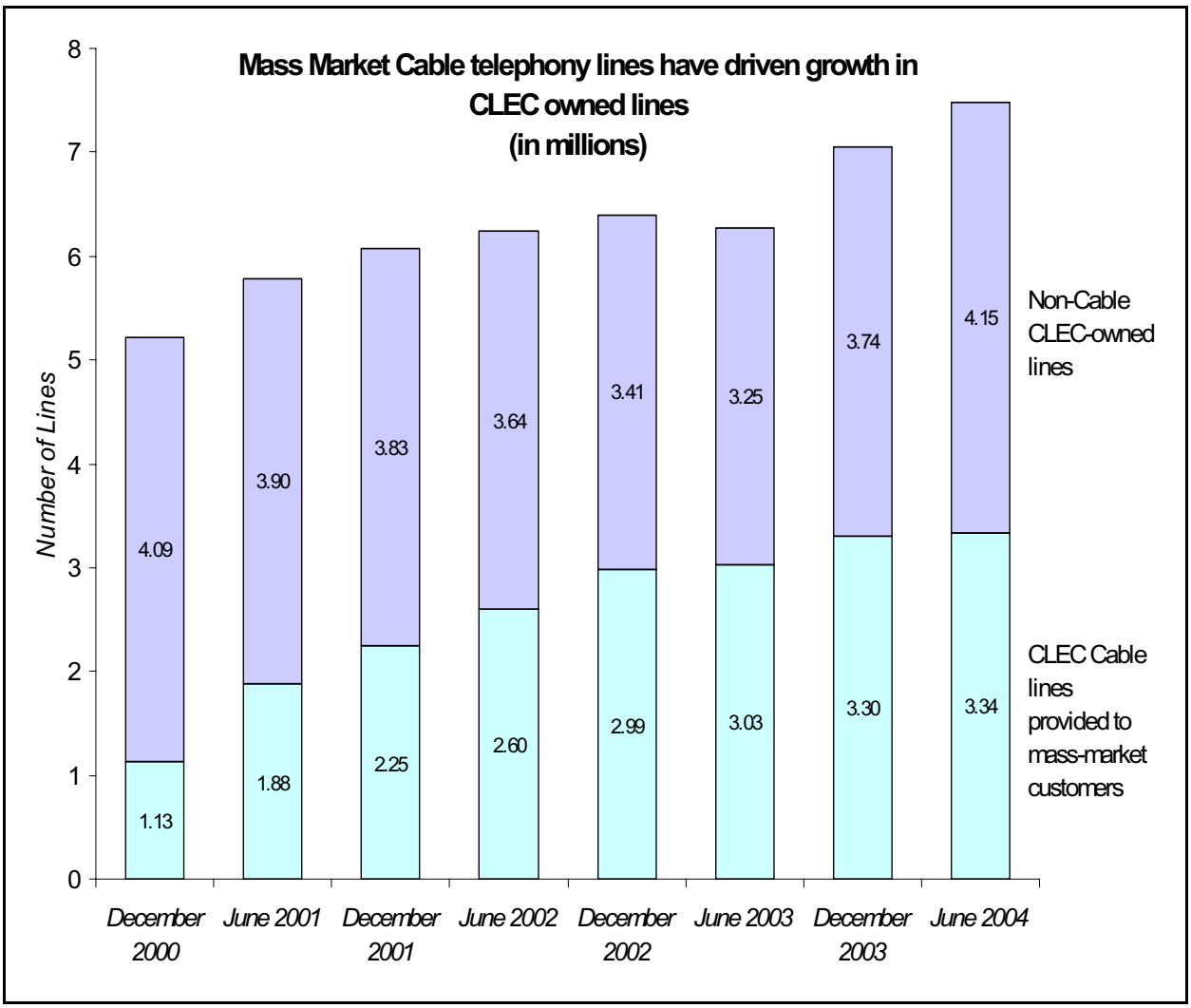
***New* Figure 2.7: Locations of SBC Special Access services being used by CLECs to provide local service to enterprise customers in the Oakland metro areas *map supplied by SBC*.**

21. Page 23 of *Reality or Illusion* cites an FCC source suggesting that 96% of high-speed cable lines are provided to residential and small business subscribers. The FCC's most recent High Speed Services for Internet Access report shows that cable companies provide 18.59-Million high speed lines, and that 18.52-Million of those lines are provided to residential

and small business users, suggesting that in fact, more than 99.5% of all cable high speed lines continue to be provided to residential and small business subscribers.

22. Page 24 of *Reality or Illusion* reported that there are only a little more than 25,000 fixed wireless high speed connections serving enterprise customers, representing two one hundredths of a percent of the 103.8-million ILEC voice-grade equivalent special access lines. Data from the FCC's most recent High Speed Services for Internet Access report, released December 22, 2004, increases that number to 34,000.

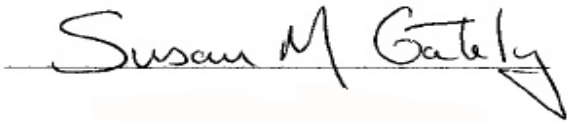
23. Figure 2.4 contained an analysis revealing that mass market cable telephony lines had driven most of the growth in CLEC-owned lines between December 2000 and June 2003. *Updated* Figure 2.4, below, carries that analysis out to June 2004 and shows no change in the data trends.



Updated **Figure 2.4. Mass market cable telephony lines account for most of the growth in CLEC-owned lines.**

VERIFICATION

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



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