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

In the Matter of	)	
	)	
Jurisdictional Separations and Referral to the Federal-State Joint Board	)	CC Docket No. 80-286
	)	
	)	

AFFIDAVIT OF

SUSAN M. BALDWIN

on behalf of the

New Jersey Division of Rate Counsel

and the

National Association of State Utility Consumer Advocates

August 22, 2006

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I. INTRODUCTION

Introduction and qualifications

1. My name is Susan M. Baldwin. I am a consultant, and my business address is 17 Arlington Street, Newburyport, Massachusetts, 01950. I provide consulting services to public sector agencies on telecommunications economics, regulation, and public policy. My statement of qualifications is included as Appendix A.

2. I have participated in numerous state proceedings regarding cost studies and cost allocation on behalf of consumer advocates and in a direct advisory capacity to state public utility commissions. Among the diverse issues that I have examined is the allocation of common plant to unregulated services, such as digital subscriber line service, to ensure that customers of intrastate regulated services do not cross-subsidize incumbent carriers' entry into new lines of business.

3. I have also participated in numerous Federal Communications Commission ("FCC" or "Commission") proceedings that bear on the Commission's policies and regulatory framework for Bell operating companies (and the way in which these Commission's policies affect mass market consumers), including, among others, regarding the Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. §160 from Enforcement of Certain of the Commission's Cost Assignment Rules, in WC Docket No. 05-342 and Qwest's Petition for Forbearance from Enforcement of the Commission's Dominant Carrier Rules as They Apply After Section 272 Sunsets, in CC Docket No. 05-333.

4. Also, I analyzed, among other issues, the implications of Bells' increasing sales of bundled services and digital subscriber line services for customers of local services (*i.e.*,

intrastate regulated services) in my analysis of recent merger applications including the Commission's investigations of the proposed mergers of SBC Communications Inc. ("SBC") and AT&T Corp. ("AT&T") in WC Docket No. 05-65,[1] Verizon Communications Inc. ("Verizon") and MCI, Inc. ("MCI") in WC Docket No. 05-75,[2] and of AT&T and BellSouth Corporation ("BellSouth") in WC Docket No. 06-74.[3]

5. I have substantial experience evaluating the status of local competition, incumbent local exchange carriers' ("ILECs") proposals for deregulation, and the consumer impact of changes in telecommunications markets.

6. I have been actively involved in public policy for twenty-eight years, twenty-two of which have been in telecommunications policy and regulation. I received my Master of Economics from Boston University, my Master of Public Policy from Harvard University's John F. Kennedy School of Government, and my Bachelor of Arts degree in Mathematics and English from Wellesley College. I have extensive experience both in government and in the private sector, and have testified before sixteen state public utility commissions and submitted numerous affidavits and comments to the Federal Communications Commission on behalf of consumer advocates, the National Association of State Utility Consumer Advocates ("NASUCA"), users, and competitive local

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[1]/ *In the Matter of Transfer of Control Filed by SBC Communications Inc. and AT&T Corp.*, FCC WC Docket No. 05-65. The New Jersey Rate Counsel submitted comments on April 25, 2005 and May 10, 2005.

[2]/ *In the Matter of Verizon Communications Inc. and MCI, Inc., Applications for Approval of Transfer of Control*, WC Docket No. 05-75, May 9, 2005. The New Jersey Rate Counsel submitted initial and reply comments on May 9, 2005, and May 24, 2005, respectively, including a declaration that I co-authored.

[3] / *In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, WC Docket No. 06-74. The New Jersey Rate Counsel submitted initial and reply comments on June 5, 2006 and June 20, 2006, respectively, including a declaration that I co-authored.

exchange carriers ("CLEC"). I also served four years as the Director of the Telecommunications Division for the Massachusetts Department of Public Utilities (now the Department of Telecommunications and Energy). My statement of qualification provides further detail.

Purposes of Affidavit

7. This affidavit was prepared at the request of the New Jersey Division of Rate Counsel ("New Jersey Rate Counsel")[4] and NASUCA[5] to address the issues raised by the Further Notice of Proposed Rulemaking ("FNPRM") released by the Commission on May 16, 2006, in CC Docket No. 80-286, in which the Commission seeks comment on

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[4] / Effective July 1, 2006, the New Jersey Division of Ratepayer Advocate is now the New Jersey Division of Rate Counsel. The Rate Counsel, formerly known as the New Jersey Ratepayer Advocate, is a Division within the Department of the Public Advocate. The Department of the Public Advocate is a government agency that gives a voice to New Jerseyans who often lack adequate representation in our political system. The Department of the Public Advocate was originally established in 1974, but it was abolished by the New Jersey State Legislature and New Jersey Governor Whitman in 1994. The Division of the Ratepayer Advocate was established in 1994 through enactment of Governor Christine Todd Whitman's Reorganization Plan. The mission of the Ratepayer Advocate is to make sure that all classes of utility consumers receive safe, adequate and proper utility service at affordable rates that are just and nondiscriminatory. In addition, the Ratepayer Advocate works to insure that all consumers are knowledgeable about the choices they have in the emerging age of utility competition. The Department of the Public Advocate was reconstituted as a principal executive department of the State on January 17, 2006, pursuant to the Public Advocate Restoration Act of 2005, P.L. 2005, c. 155 (*N.J.S.A.* §§ 52:27EE-1 et seq.). The Department is authorized by statute to "represent the public interest in such administrative and court proceedings . . . as the Public Advocate deems shall best serve the public interest," *N.J.S.A.* § 52:"27EE-57, *i.e.*, an "interest or right arising from the Constitution, decisions of court, common law or other laws of the United States or of this State inhering in the citizens of this State or in a broad class of such citizens." N.J.S.A.§52:27EE-12, and the office of the Rate Counsel, formerly known as the Ratepayer Advocate, became a division therein to continue its mission of protecting New Jersey ratepayers.

[5] / NASUCA is a voluntary association of 45 advocate offices in 42 states and the District of Columbia, incorporated in Florida as a non-profit corporation. NASUCA's members are designated by laws of their respective jurisdictions to represent the interests of utility consumers before state and federal regulators and in the courts. See, e.g., Ohio Rev. Code Chapter 4911; 71 Pa. Cons. Stat. Ann. § 309-4(a); Md. Pub. Util. Code Ann. § 2-205(b); Minn. Stat. § 8.33; D.C. Code Ann. § 34-804(d). Members operate independently from state utility commissions as advocates primarily for residential ratepayers. Some NASUCA member offices are separately established advocate organizations while others are divisions of larger state agencies (*e.g.*, the state Attorney General's office). NASUCA's associate and affiliate members also serve utility consumers but are not created by state law or do not have statewide authority.

matters relating to the reform of the separations process.[6] The purpose of this affidavit is to ensure that, in their examination of complex cost accounting systems, federal regulators do not lose sight of the interests of consumers, who ultimately bear the cost of outdated cost accounting systems and who ultimately pay the price for the misallocation and mis-assignment of costs.

Summary

8. Among my major conclusions and recommendations are the following:

- Unless and until state regulators exercise their existing rate-making authority and the Commission clarifies its cost accounting rules, consumers of intrastate regulated services will bear unfairly the cost of billions of dollars of carriers' investment in plant and related expenses that should be instead assigned and allocated to interstate services and unregulated services.
- Numerous factors have created a gross mismatch between the current accounting of carriers' revenues and costs including, among others: the Bells' pursuit of unregulated lines of business (such as DSL and video services); the Bell's bundles (which mingle intrastate, interstate, regulated, and unregulated products); the Commission's declaration that wireline broadband services are information services; and the increase in VoIP and ISP-bound traffic that the Commission has said is interstate.
- These seismic technological, regulatory, and marketing changes warrant a close examination of costs and rates by federal and state regulators to ensure

[6] / *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Order and Further Notice of Proposed Rulemaking,* released May 16, 2006 ("FNPRM").

that intrastate services are not subsidizing interstate services and to ensure that regulated services are not subsidizing unregulated services.

- States should not await the Commission's completion of this complex proceeding before commencing their review of intrastate rates.
- Delay in re-initializing excessive state rates harms consumers and therefore the Commission should issue an interim order that eliminates any residual uncertainty about states' rights to remove the costs of non-regulated and interstate activities from intrastate rates.
- Carriers' new ventures "free-ride" over a common platform, which yield excessive interstate and intrastate regulated rates.
- The Commission should reject the increase in the subscriber line charge proposed in the "Missoula Plan" unless and until a close examination of carriers' cost justifies such an increase.
- Neither existing levels of competition nor the existence of alternative forms of regulation protect consumers from today's distorted rates, which are based on outdated cost accounting rules, and carriers' failure to comply with existing rules.
- The Commission should reject BellSouth's petition for forbearance from cost allocation rules because, among other reasons, price cap regulation does not eliminate the need for cost accounting, competitive forces do not yet discipline BellSouth's regulated rates, and regulators' need for cost data outweighs any purported burden to BellSouth of providing such data.

- The Commission should eliminate ambiguity about carriers' cost accounting treatment of their unbundled network elements by aligning costs and revenues for these services.
- The Commission should issue a detailed data request in a timely manner to inform regulators' efforts to modify cost accounting rules.

An improved system of separations and cost accounting would facilitate regulators' ability to ensure that consumers of intrastate regulated services pay just and reasonable rates.

9. The way in which the Commission resolves the complex matters under investigation in this proceeding bears directly on consumers' intrastate and interstate telecommunications charges, on the magnitude of total costs for which Bell operating companies ("Bells")[7] may seek recovery in state regulatory proceedings, and the interplay between incumbent carriers and competitors. As legacy AT&T aptly observed: "[i]t is undisputed that the incumbent LECs remain the dominant providers of local services within their service territories, and that they retain significant incentives and ability to discriminate and misallocate costs."[8]

10. The Commission's proceeding focuses on jurisdictional separations (Part 36 of the Commission's rules),[9] but appropriately recognizes that the convergence of

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[7] / This affidavit focuses primarily on the costs, revenues, services, and business strategies of the four Bell operating companies, but many of the concerns apply equally to all independent local exchange carriers.

[8] / *Federal-State Joint Conference on Accounting Issues, WC Docket No. 02-269, 2000 Biennial Regulatory Review - Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase II*, CC Docket No. 00-199, *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Local Competition and Broadband Reporting, CC Docket No. 99-301*, Comments of legacy AT&T Corp., January 30, 2004, at 2.

[9] / 47 C.F.R. Part 36.

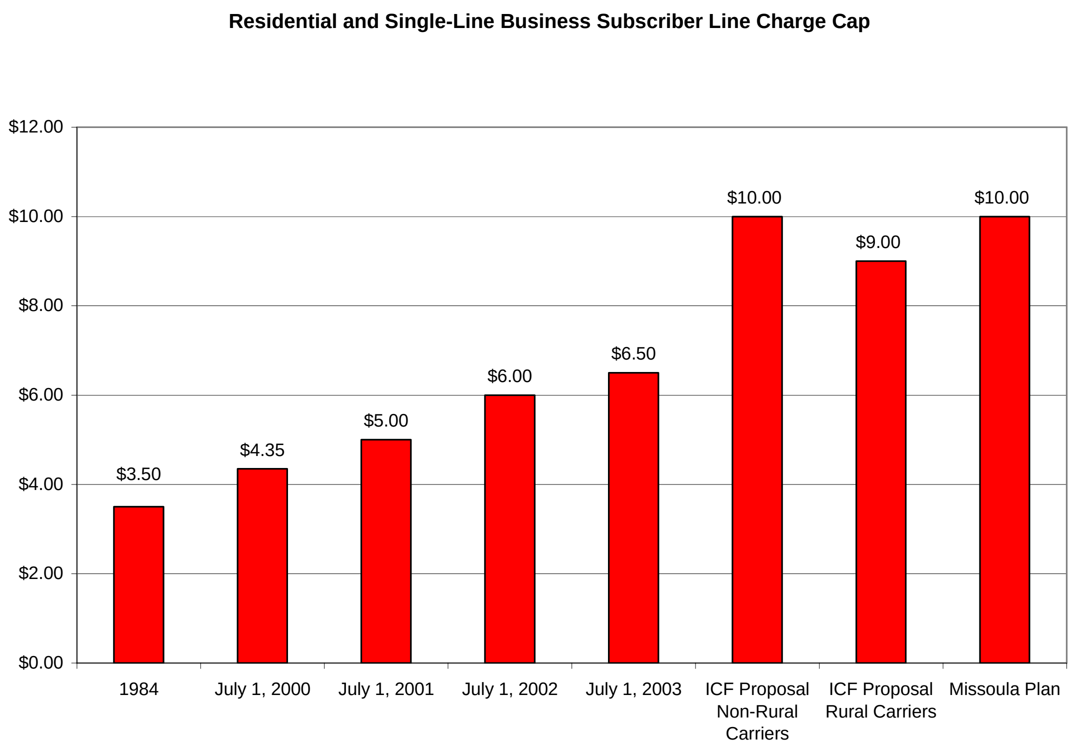
technology, industry structure, and regulation means that the Commission should consider its cost accounting rules more broadly.[10] For example, using Part 64 rules, regulators should ensure that ILECs assign greater percentages of their plant and expenses to unregulated services than they now do *before* even considering how ILECs, pursuant to the Commission's Part 36 rules, separate costs between the interstate and intrastate jurisdictions. Shifting costs to the interstate side of the jurisdictional demarcation line may protect consumers from inappropriately high *intrastate* rates, [11] but does not protect consumers from cross-subsidizing competitive ventures with consumer-funded *interstate* subscriber line charges, which, as Figure 1 below shows, have been steadily increasing.[12]

[10] / As the "Glide Path II Paper," which is included as Appendix B to the *FNPRM* explains: "The FCC has classified several services as 'information services' under "Title I" since TA96. It is unclear whether costs of services classified as information service[s] cam legally be allocated or assigned to either the interstate or the intrastate jurisdiction, as the FCC's Part 36 jurisdictional separations rules are currently promulgated under Title II. If revenues are treated under Title I then associated costs should be removed from under Title II. It is unclear whether appropriate[ ] accounting treatment of these changes has been implemented." Glide Path II Paper, at 8.

[11] / Part 32 of the FCC's rules entails the use of the Uniform System of Accounts ("USOA") to record investments and accounts. Part 64 assigns costs to regulated and nonregulated activities. Part 36 involves jurisdictional separations between intrastate and interstate jurisdictions. Part 69 requires carriers to separate interstate regulated costs among the interexchange services and rate elements. *FNPRM*, at para. 3.

[12] / Industry pressure to raise the SLC continues as is evidenced by the recent submission of the "Missoula Plan" in the Commission's intercarrier compensation proceeding. FCC Public Notice, "Comment Sought on Missoula Intercarrier Compensation Reform Plan," CC Docket No. 01-92, DA 06-1510, July 25, 2006.

Figure 1[13]



11. These principles pertain to all charges that are passed on to end users, whether imposed by federal or state regulators. As the *Glide Path II Paper* states: "They [the authors of the first Glide Path paper] stated that customers care little whether the charges on their bills are the result of federal or state action, but that they do care about the relationship between flat rate and usage-based charges."[14]

[13] / Sources: *Cost Review Proceeding for Residential and Single-Line Business Subscriber Line Charge (SLC) Caps, Access Charge Reform*, CC Docket No. 96-262, *Order*, Rel. June 5, 2002, at para. 4; *CALLS Order*,at para. 85; *In the Matter of Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92, *Further Notice of Proposed Rulemaking*, Rel. March 3, 2005, at para. 42; FCC Public Notice, "Comment Sought on Missoula Intercarrier Compensation Reform Plan," CC Docket No. 01-92, DA 06-1510, July 25, 2006.

[14] / "Post-Freeze Options for Separations," State Members of the Separations Joint Board, October 25, 2005, included as Appendix B to the *FNPRM* ("Glide Path II Paper"), at 4.

Consumers of intrastate regulated services unfairly foot the bill for unregulated services and services that are jurisdictionally interstate.

12. As this affidavit demonstrates, consumers of intrastate regulated services are bearing unfairly the cost of billions of dollars of carriers' investment in plant and related expenses that should be assigned and allocated to unregulated lines of business and interstate services. Numerous factors create a gross mismatch between carriers' accounting of their revenues and costs including: the Bells' pursuit of unregulated lines of business; the Bells' increasing sales of long distance and bundled services which mingle intrastate, interstate, regulated, and unregulated products; the Commission's declaration that wireline broadband services are information services; and the increase in VoIP and ISP-bound traffic that the Commission has classified as interstate. These seismic changes justify a close examination of costs and rates by federal and state regulators.

13. Distorted intrastate and interstate rates create a compelling need for federal and state regulators to examine costs and rates (1) to ensure that regulated services are not cross-subsidizing unregulated services and (2) to lower intrastate regulated rates based on an allocation and assignment of carriers' plant to interstate and unregulated operations.

14. The Commission should debunk the carriers' myths at the outset. Despite carriers' assertions to the contrary, neither existing levels of competition nor the existence of alternative forms of regulation protect consumers adequately from distorted rates, which are based on an outdated cost accounting system and Bells' refusal to comply with existing cost rules.

Cost accounting rules are more relevant than ever as Bells embark on new lines of business and as a result of the evolving jurisdictional treatment of new services.

15. Bells contend that separations and cost accounting procedures are irrelevant.[15] However, in the absence of effective competition, and as the Bells re-monopolize telecommunications markets, cost accounting data are critical so that regulators can detect and discourage anti-competitive cross-subsidization of nonregulated and/or competitive services with revenues from regulated services.[16] Furthermore, state regulators require cost accounting data for diverse purposes including, among other things, to assess whether intrastate rates are just and reasonable, to determine the need, if any, for intrastate universal service support, and to evaluate the reasonableness of rates for unbundled network elements ("UNE").

16. Cost accounting rules have not kept pace with the emergence of new technology and regulatory changes. Many major factors have created a substantial mismatch between intrastate regulated revenues, which exclude services such as digital subscriber line ("DSL"), and intrastate regulated costs, which are based on the fixed intrastate/interstate allocation factor of 75%/25% for the local loop (the feeder and distribution networks and associated expenses), and frozen usage factors. Among the

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[15] / *See, e.g.*, Petition of BellSouth Telecommunications, Inc. for Forbearance Under 47 U.S.C. § 160 From Enforcement of Certain of the Commission's Cost Assignment Rules, WC Docket No. 05-342, filed December 6, 2005 ("BellSouth Petition"), United States Telecom Association White Paper: "Paving the Way for Jurisdictional Separations Reform," December 12, 2005 ("US Telecom White Paper").

[16] / Local exchange carriers should continue to be subject to the requirements of the *Competitive Fifth Report and Order* and the separate accounting and ownership requirements should continue after Section 272 requirements sunset to prevent anticompetitive and discriminatory behavior. Given the continued market power of the Bells in relevant markets, structural safeguards are critical. *See, In the Matter of Section 272(f)(1) Sunset of the BOC Affiliate and Related Requirements*, WC Docket No. 02-112; *2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules*, CC Docket No. 00-175, *Further Notice of Proposed Rulemaking*, Rel. May 19, 2003, at paras. 4-7.

changes that render these frozen factors grossly incorrect are the deployment of new technologies such as DSL and fiber to the home and curb; jurisdictional changes such as the treatment of broadband,[17] voice over Internet protocol ("VoIP"),[18] and calls to Internet service providers;[19] and Bells' Section 271 authority to offer long distance service.

The Commission should clarify that states have the authority, indeed the duty, to ensure that carriers assign and allocate costs properly so that states can fulfill their responsibility to establish just and reasonable rates for local services.

17. Although a carefully considered overhaul of the Commission's cost accounting rules is long overdue, during this period of re-assessment by the Commission, it is critically important that the Commission acknowledge and clarify states' unique

[17] / The Commission determined that DSL service is interstate in 1998. *GTE DSL Order*, 13 FCC Rcd at 22474-83. The Commission subsequently determined that wireline broadband Internet service is an information service. *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, Universal Service Obligations of Broadband Providers*, CC Docket No. 02-33, et al., *Report and Order and Notice of Proposed Rulemaking*, 20 FCC Rcd 14853 (2005) (" Broadband Sharing Order"),

[18] / In 2004, the Commission adopted the *Vonage Order* in which it declared that it had jurisdiction over VoIP services. *Vonage Holdings Corporation for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, WC Docket No. 03-211, *Memorandum Opinion and Order*, 19 FCC Rcd 22404 (2004) ("Vonage Order"). The Commission released an order in the summer of 2005 requiring interconnected VoIP providers to provide enhanced 911 by November 28, 2005. *In the Matters of IP-Enabled Services; E911 Requirements for IP-Enabled Service Providers*, FCC WC Docket Nos. 04-36; 05-196, *First Report and Order and Notice of Proposed Rulemaking*, Adopted May 19, 2005, Rel. June 3, 2005 ("VoIP E911 Order"). Most recently, the Commission determined that interconnected VoIP providers should contribute to the USF. *In the Matter of Universal Service Contribution Methodology*, WC Docket No. 06-122*; Federal-State Joint Board on Universal Service*, CC Docket No. 96-45*; 1998 Biennial Regulatory Review – Streamlined Contributor Reporting Requirements Associated with Administration of Telecommunications Relay Service, North American Numbering Plan, Local Number Portability, and Universal Service Support Mechanisms*; CC Docket No. 98-171; *Telecommunications Services for Individuals with Hearing and Speech Disabilities, and the Americans with Disabilities Act of 1990*, CC Docket No. .90-571; *Administration of the North American Numbering Plan and North American Numbering Plan Cost Recovery Contribution Factor and Fund Size*, CC Docket No. 92-237, NSD File No. L-00-72; *Number Resource Optimization*, CC Docket No. 99-200; *Telephone Number Portability*, CC Docket No. 95-116; *Truth-in-Billing and Billing Format*, CC Docket No. 98-170; *IP-Enabled Services*, WC Docket No. 04-36, *Report and Order and Notice of Proposed Rulemaking*, Rel. June 27, 2006 ("USF Contribution Order").

[19] / The Commission has determined that communications to Internet service providers ("ISP") is an interstate service. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, *Intercarrier Compensation for ISP-Bound Traffic*, CC Docket No. 99-68, *Order on Remand and Report and Order*, FCC 01-131 (released April 27, 2001).

responsibility to ensure that consumers pay just and reasonable rates for local services. Certainly, improved cost accounting rules, which may result ultimately from this proceeding, would provide better informational tools for federal and state regulators. However, even under the existing cost accounting rules, states can and should continue to apply their rate-making expertise to fulfill their mandate to set fair and efficient intrastate rates for regulated services. Indeed for states to await the resolution of the pending proceeding (which, in light of its history might not occur until several years in the future), *before* examining Bells' assignment and allocation of costs, would irrevocably harm consumers. Carriers' attempts to prevent state regulators' analysis of carriers' costs during the "freeze" would restrict unduly state regulators' ability to establish just and reasonable rates, and therefore should be rejected resoundingly by the Commission.

States have the authority to remove costs associated with non-regulated services.

18. The Commission appropriately stated that "state jurisdictions have the ability to remove the costs of state non-regulated activities so that those costs will not be recovered in regulated intrastate service rates."[20] The Commission should issue an interim order in this proceeding that encourages states to apply their existing authority to remove costs associated with non-regulated services and activities from intrastate rates. As I demonstrate later in my affidavit, billions of dollars are at stake, and, presently, are being borne unfairly by consumers of local services. Consumers of local services will continue to pay excessive rates unless and until state regulators affirmatively exclude such costs and re-initialize rates.

[20] / *FNPRM*, at footnote 6.

The Separations Joint Board recognizes the duty of states to ensure that universal service "bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."

19. In its *Glide Path II Paper*, the Federal-State Joint Board on Jurisdictional Separations ("Joint Board") states that "Section 254(k) of the 1996 Act establishes a *duty* for the FCC and the states" to ensure that universal service "bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[21] Section 254(k) states:

> The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.[22]

States must analyze incumbents' cost accounting to fulfill their responsibility as set forth in the 1996 Act.

The Commission should clarify unambiguously that states have the authority to ensure that carriers directly assign private lines and special access circuits.

20. The Commission, in its *FNPRM*, recognizes the disagreement between state regulators and the industry regarding the assignment of private lines and special access circuits.[23] As explained by the Commission, "the NARUC Board of Directors adopted a resolution stating that the Commission 'should clarify that all carriers must continue to directly assign all private lines and special access circuits based on existing line

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[21] / *Glide Path II Paper*, at 8, emphasis added.

[22] / 47 U.S.C.§ 254(k).

[23] / *FNPRM*, at para. 38.

counts'"[24] and "[c]onversely, US Telecom requests that the Commission 'reaffirm' that, under the *2001 Separations Freeze Order*, state regulators may not compel LECs to reallocate catetgories of investment from the intrastate to the interstate jurisdiction while the freeze remains in effect."[25]

21. In its resolution, NARUC stated:

> RESOLVED, The FCC should clarify that all carriers must continue to directly assign all private lines and special access circuits based on existing line counts in such a manner that the Joint Board will be able to complete its work before the extended freeze expires.[26]

NARUC further explained that when the Joint Board "recommended a freeze in 2000, the Joint Board relied on the updating of direct assignments to offset the effect of increased sales of interstate private line and special access services, but at least some carriers are not performing these annual adjustments, thus allowing a further mismatch between interstate costs and revenues."[27]

22. As I demonstrate later in my affidavit, Bells are deriving an increasing percentage of their total revenues from interstate services, in large part because of increasing demand for interstate private lines and special access circuits. This evolving consumer demand underscores the importance of the Commission clarifying that states may and indeed should ensure that carriers directly assign private lines and special access circuits.

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[24] / *Id.*, citing *Resolution Relating to Separations Reform*, NARUC (February 15, 2006).

[25] / *Id.*, citing *US Telecom White Paper*

[26] / http://www.naruc.org/associations/1773/files/TCOM-2SeparationsReform.pdf The entire NARUC resolution is included as Appendix B to my affidavit.

[27] / *Id.*

23. In sharp contrast with NARUC's resolution, US Telecom argued that "[under the *Separations Order*, LECs are not required to conduct investment studies, which . . . are necessary prerequisites to direct assignment."[28] US Telecom's White Paper provides compelling evidence of the critical need for the Commission to clarify states' authority to require direct assignment of private line and special access circuits. Among other things, US Telecom states that "notwithstanding the Commission's decision to freeze category relationships and jurisdictional cost allocation factors, certain state commissions have taken the position that carriers must reallocate major portions of their network investment to the interstate private line category."[29]

24. Countering US Telecom's assertion is a reply declaration submitted by AT&T and BellSouth in their merger proceeding that attempts to justify the high rates of return earned by carriers from their special access service, in part, by observing that the "FCC's cost allocation rules relating to these services are based on cost studies from the late 1990s and have been frozen since 2001. Since that time, however, there has been a substantial divergence in demand for special access and switched access revenues."[30] The declaration also quotes comments filed by legacy SBC in a different proceeding stating, among other things:

> ARMIS results . . . understate the costs an ILEC incurs to provide any service that has experienced significant growth in volumes. The costs for interstate special access services are particularly susceptible to this

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[28] / *US Telecom White Paper*, at 11.

[29] / *Id.*, at 10-11, citing investigations by the Vermont Public Service Board and the Maine Public Utilities Commission.

[30] / *In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, WC Docket No. 06-74, Reply Declaration of Dennis W. Carlton and Hal S. Sider, June 19, 2006 ("Carlton/Sider Reply Declaration"), at para. 30.

> understatement because demand has increased dramatically over the past several years with the explosive growth in data services. The result is a mismatch between costs which do not properly reflect current utilization and volumes and revenues which do. This mismatch, of course, will overstate the calculated rate of return.[31]

25. In one proceeding, industry members acknowledge the cost-revenue mismatch arising from the explosive growth in data services as a way to "excuse" high interstate rates of return,[32] and in this proceeding, seek to preclude states from correcting this mismatch. The consequence of these two simultaneous industry arguments, if unaddressed by regulators, would be exorbitant *interstate* special access rates and excessive *intrastate* regulated rates. The purpose of separations is to "prevent incumbent LECs from recovering the same costs in both the interstate and intrastate jurisdictions."[33] The industry is gaming the process to avoid lowering either interstate or intrastate rates.

26. The Commission should issue an interim order that eliminates any lingering uncertainty about states' existing authority to require carriers to assign directly all private lines and special access circuits based on existing line counts.

State consumer advocates' and state regulators' focus on costs is more important than ever to protect consumers from exorbitant rates.

27. By acquiring MCI and legacy AT&T, the Bells have silenced significant and valuable independent voices in regulatory proceedings. In this newly created vacuum, the responsibility of regulators and consumer advocates to question and analyze the

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31 / *Id.*, at para. 32, quoting comments of David Toti, then the Executive Director – Regulatory Accounting for SBC.

32 / *In the Matter of Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25; *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593, Comments of Qwest Communications International, Inc., June 13, 2005, at 4, 11; Comments of the United States Telecom Association, June 13, 2005, at 11-13; Comments of Verizon, June 13, 2005, at 21.

33 / *FNPRM,* at para. 2, footnote omitted.

impact of the separations process on consumers and competitors has become that much more important. Delay in fixing the present misallocation of costs helps the industry and harms consumers. Furthermore, the industry lacks an incentive to resolve these issues. An examination is long overdue to prevent customers of noncompetitive services from subsidizing ILECs' forays into new lines of business through supracompetitive rates.

II. FURTHER NOTICE OF PROPOSED RULEMAKING

The separations process is intended, among other things, to ensure that carriers do not over-recover relevant costs from intrastate and interstate jurisdictions.

28. The jurisdictional separations process determines the manner in which ILECs apportion regulated costs among jurisdictions (*i.e.*, interstate and intrastate jurisdictions).[34] As the FCC notes in its *FNPRM:* "one of the primary purposes of the separations process has been to prevent incumbent LECs from recovering the same costs in both the interstate and intrastate jurisdictions."[35] In conducting the jurisdictional separations process, carriers first assign the regulated cost of categories of plants and expenses (and sometimes among services with those categories). Carriers then allocate the costs in each category to the intrastate or interstate jurisdiction based upon: a relative use factor, a fixed allocator, or, by direct assignment (when allowed by Part 36 rules[36]).[37]

29. In 1997, the Commission commenced a proceeding to investigate whether it should reform the separations process in response to market, technological and legislative changes; sought comments on several proposals; and asked the Joint Board to prepare a report on the matter.[38] The Joint Board filed its report in December of 1998 and further issued a Recommended Decision for an interim freeze of the Part 36 allocation factors

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34 / In my affidavit, I rely on data reported by the four Bell operating companies (AT&T, BellSouth, Qwest, and Verizon) to regulators and to their investors to illustrate the magnitude of the dollars at stake in the cost accounting process. However, the analyses apply broadly to all incumbent local exchange carriers.

35/ *FNPRM*, at para. 2.

36/ *Id.*, at para. 4.

37/ 47 C.F.R. Part 69.

38/ *FNPRM*, at para. 5, citing *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Notice of Proposed Rulemaking*, 12 FCC Rcd 22120, 22126-22131(1997), paras. 9-19 ("1997 Separations Notice").

and category relationships in July, 2000.[39] The Commission adopted the Joint Board's recommendation in 2001 concluding that the freeze would "provide stability and regulatory certainty for carriers" during what was thought to be a transition from regulated monopoly to a deregulated, competitive environment.[40]

30. In December 2001, the State Members of the Joint Board filed the *Glide Path Paper* outlining seven options for reforming the separations process.[41] The Wireline Competition Bureau sought comment on the *Glide Path Paper* in December, 2001 and an en banc hearing was held in February, 2002 to discuss reform proposals.[42] In May 2004, the State Members proposed to Federal Members that a data request be issued to carriers and further, in October 2004, proposed that a Notice of Proposed Rulemaking be issued and that data requests be included in the Notice.[43]

31. In October 2005, the State Members of the Joint Board updated the *Glide Path Paper* including six options for reform, similar to the original six options: (1) allowing the freeze to expire; (2) extending the separations freeze; (3) adopting fixed allocators to separate traffic sensitive costs; (4) interstate services set by Commission and state use of residuals methods to set intrastate rates; (5) coordination of separations changes with

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[39]/ *FNPRM*, at paras. 6-7.

[40]/ *Id.*, at 8, citing *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Report and Order*, 16 FCC Rcd 11382 (2001)("2001 Separations Freeze Order"). The FCC adopted a freeze for then current Part 36 category relationships and cost allocation factors. The freeze was to expire on June 30, 2006. *Id.*, at para. 1.

[41]/ Letter from David J. Lynch, Iowa Utilities Board, to Magalie Roman Salas, FCC, filed Dec. 17, 2001, attaching "Options for Separations: A Paper Prepared by the State Members of the Separations Joint Board" ("Glide Path Paper").

[42]/ *FNPRM*, at para. 11.

[43]/ *Id.*, at para. 12.

universal service and intercarrier compensation changes; and (6) ending the separations regime altogether.[44]

32. In December 2005, the United States Telecom Association filed a white paper with the Commission seeking an extension of the separations freeze.[45]

33. The *Order*[46] extended the current separations freeze originally established in 2001 for a period no longer than three years or until "comprehensive reform can be completed."[47] The *FNPRM* asks commenters to "refresh the record" with respect to the 1997 Separations Notice; seeks comment on the proposals for reform put forth by State Members of the Joint Board; and seeks comments regarding the draft data request prepared by State Members of the Joint Board.[48]

34. In discussing why competition and new technologies suggest a need for changes in the separations process, the Commission explains:

> Jurisdictional cost shifts in separations results generally are caused by changes in any of three areas: overall cost levels, categorization of costs (i.e., relative category assignments), or jurisdictional allocation factors. A carrier's increased overall cost level in a Part 32 account that has a high cost allocation to the interstate jurisdiction will cause shifts to the

[44]/ *Id.*, at para. 13, citing Letter from James Bradford Ramsay, General Counsel, National Association of Regulatory Utility Commissioners (NARUC), to Marlene H. Dortch, Secretary, Federal Communications Commission, CC Docket No. 80-286 (filed May 1, 2006) (NARUC May 1, 2006 Letter), Att., *Glide Path II Paper*.

[45]/ *Id.*, at para. 14.

[46]/ *FNPRM.*

[47]/ *Id.*, at para. 16. *See, also, 2001 Separations Freeze Order*. The FCC adopted a freeze for then current Part 36 category relationships and cost allocation factors. The freeze was to expire on June 30, 2006. *FNPRM*, at para. 1. Comments are to be filed no later than August 22, 2006 and reply comments are to be filed with the Commission no later than November 20, 2006. *Federal Register*, Vol. 71 No. 100, May 24, 2006, at 29882. The frozen category relationships and the frozen allocation factors are based on carriers' data from calendar-year 2000. *FNPRM*, at footnote 25, citing *2001 Separations Freeze Order*, 16 FCC Rcd at 11387-88, para. 9.

[48]/ *FNPRM*, at paras. 26-38.

> interstate jurisdiction for other investment and expense accounts whose jurisdictional allocations are dependent on that account. Increasing investment in specific categories (e.g., interexchange cable and wire facilities (C&WF)) may also contribute to jurisdictional shifts in the final results. Likewise, changes in customer calling patterns (e.g., increased interstate calling) will cause shifts in the jurisdictional allocation factors, many of which are based on usage. These factors allocate a significant portion of a carrier's investment between the interstate and intrastate jurisdictions.[49]

35. In the months following the Joint Separations Board release of its *Glide Path II Paper*, their first two options – allowing the freeze to expire and extending the freeze – have become irrelevant (at least during the next three years). Despite consumer advocates' concerns, the Commission extended the separations freeze, thereby facilitating Bells' ability to perpetuate a mismatch between their assignment and allocation of costs and revenues.

36. The third option (adopting fixed allocators to separate traffic sensitive costs) would not seem to remedy the severe imbalance discussed above regarding cost accounting for common local loop that supports DSL, and other unregulated lines of ILECs' business.

37. The fourth option would seem to allow the Commission to usurp states' rate-setting responsibility by leaving them with "residual" costs to recover. Also, as the *Glide Path II Paper* aptly recognizes:

> [I]nterstate rates might be too low to carry a fair share of the burden of supporting the network. The state jurisdiction could also become responsible for cost recovery of both state and interstate embedded legacy costs if the interstate jurisdictional cost assignment was based on a forward looking model.[50]

49/ *Id.*, at footnote 23.

50 / *Glide Path II Paper*, at 12.

38. The fifth option recommends the coordination of separations charges with universal service and intercarrier compensation charges. As I discuss in my affidavit, certainly the Commission should coordinate its policy making among related proceedings, and therefore should coordinate changes with universal service and intercarrier compensation to the extent that these proceedings are related. However, the need for separations reform should not be held hostage to other proceedings, nor should any coordination with other proceedings discourage states from independently examining the reasonableness of carriers' cost assignment and cost allocation.

39. The sixth option would end the separations regime altogether. Unless and until effective competition disciplines ILECs' market power, federal and state regulators require access to cost accounting information to fulfill their responsibility to ensure that rates are just and reasonable and that ILECs do not over-recover their costs in the two distinct jurisdictions. Therefore, the Commission should reject the sixth option set forth in the *Glide Path II Paper*.

Unless and until Congress and the Commission revise the legal framework, Bells should comply with cost accounting standards.

40. Among other things, the Commission seeks comment on "whether competitive neutrality, administrative simplicity, and principles of cost causation still should be the primary criteria for evaluating proposals for reform of the separations rules, or whether other criteria should be balanced in addition to or in place of these criteria."[51] This affidavit responds to that request.

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[51] / *FNPRM*, at para. 28, cite omitted.

41. Competitive neutrality, administrative simplicity, and cost causation continue to be appropriate criteria for evaluating proposals. In addition, the Commission should consider whether proposals for reform achieve the objective of ensuring that customers of local services do not cross-subsidize carriers' entry into new lines of business and do not support services that have been deemed either unregulated or interstate.

42. Section 254(k) of the Telecommunications Act of 1996[52] requires the Commission and states to establish rules, safeguards and guidelines to ensure that "services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services." The existing rules fail to achieve that directive. Regulators' ability to meet this statutory directive depends on their access to ILECs' cost data and on regulators' willingness to analyze these data.

[52] / Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act"). The 1996 Act amended the Communications Act of 1934. Hereinafter, the Communications Act of 1934, as amended by the 1996 Act, will be referred to as "the 1996 Act," or "the Act," and all citations to the 1996 Act will be to the 1996 Act as it is codified in the United States Code.

III. WHY SEPARATIONS AND COST ACCCOUNTING MATTER TO CONSUMERS

The separations process matters even if states regulate ILECs under alternative regulation: the Commission should reject BellSouth's Petition for Forbearance.

43. As the Commission assesses options for reforming its cost accounting system, certain themes are likely to emerge in the regulated companies' arguments, many of which can be debunked at the outset. One myth is that price cap or alternative regulation obviates the need for cost data. States that have de-regulated or relaxed the regulation of local rates may consider separations to be an arcane and irrelevant concern: since a price cap plan, for example, may govern rate changes, the underlying costs seemingly are no longer an issue of concern.

44. BellSouth raises precisely this argument in its petition for forbearance from the Commission's cost allocation rules.[53] In its *FNPRM*, the Commission, among other things, seeks comment "on the effect of a Commission grant or denial of the *BellSouth Cost Assignment Forbearance Petition* on comprehensive separations reform, and vice-versa."[54] In initial and reply comments opposing BellSouth's petition, the New Jersey Rate Counsel demonstrated the harm to consumers and to the public interest that would ensue from granting BellSouth's petition, and explained why price cap regulation does not obviate the need for carriers' compliance with cost accounting.[55] The rationale

[53] / BellSouth Petition. BellSouth's Petition includes nine appendixes, which provide details about the rules affected by its Petition, an overview of the price cap rules which govern its intrastate rates, details on its cost allocation methodology, the impact of its petition on ARMIS reporting, and information about oversight of accounting and financial matters.

[54] / *FNPRM*, at para. 37.

[55] / *See, Petition of BellSouth Telecommunications, Inc. for Forbearance Under 47 U.S.C.§ 160 from Enforcement of Certain of the Commission's Cost Assignment Rules*, WC Docket No. 05-342, initial and reply comments of the New Jersey Division of the Ratepayer Advocate, January 23, 2006, submitted January 23, 2006, and February 10, 2006.

continues to apply in today's telecommunications markets. Among other reasons set forth in the comments are the following:

> Until the Commission renders a decision in WC Docket 05-25, which, among other things, entails an examination of the supracompetitive prices being charged by incumbent local exchange carriers ("ILEC"), faith in the interstate price cap system's ability to yield just and reasonable rates would be seriously misplaced.

The New Jersey Rate Counsel further explained:

> First, it is entirely inappropriate to up-end a complex system of regulatory cost allocation and reporting, upon which both federal and state regulators rely, through a petition submitted by a single regional Bell operating company ("RBOC") for forbearance. Second, BellSouth's Petition bears directly on states' access to valuable data and information, and, therefore, the Commission's deliberations in this proceeding could affect states' ability to carry out their regulatory responsibilities. As has been the Commission's long tradition, states and the Commission should work collaboratively on matters of such complexity and importance to interstate and intrastate ratesetting. Third, the Petition raises matters that potentially affect all ILECs, and, therefore, these matters would be better aired in a rulemaking, that would be informed by the recommendations of a federal-state joint board. Indeed unless the Commission intends to refer the matters raised by BellSouth's Petition to a more detailed analysis conducted with federal-state cooperation, it would be imprudent for the Commission to limit the review of BellSouth's Petition to the abbreviated comment cycle in the instant proceeding.[56]

For these and the other reasons set forth in the initial and reply comments submitted by the New Jersey Rate Counsel, the Commission should deny BellSouth's petition.

45. Regardless of whether a carrier is subject to alternative or traditional rate of return regulation, regulators require meaningful cost accounting data in order to ensure that regulated rates are just and reasonable. Establishing just and reasonable going-in rates, and assessing the impact of exogenous events (such as changes in separations and other

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[56] / *Petition of BellSouth Telecommunications, Inc. for Forbearance Under 47 U.S.C.§ 160 from Enforcement of Certain of the Commission's Cost Assignment Rules*, WC Docket No. 05-342, Initial Comments of the New Jersey Division of the Ratepayer Advocate, January 23, 2006, at 3-4.

cost accounting rules) on price cap and alternative regulation plans requires an assessment of a carrier's revenue requirement: if ILECs assign and allocate excess amounts to the intrastate jurisdiction, then state rates will be too high.[57]

46. Another limitation of price cap plans is that ILECs have an economic incentive to bring exogenous events that *raise* their costs to the attention of regulators but lack a corresponding incentive to alert regulators to exogenous events that *lower* their regulated costs. This is evidenced by the recent order approving AT&T's request for exogenous treatment of local number portability ("LNP") costs.[58] If price cap regulation worked efficiently, major exogenous events such as jurisdictional and regulatory shifts in the treatment of VoIP, ISP-bound traffic, and DSL should lead to a decline in rates under price caps. Federal and state rates, set by price caps, require re-initialization to address these major exogenous events.

47. Bells are entering video markets, yet are not providing regulators with data about how they account for these new costs. Also, alternative regulation plans with fixed terms may require data to determine whether rates are just and reasonable.

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[57] / A Court decision in 2005 provides further evidence of the need for cost studies, even when carriers are governed by alternative forms of regulation ("AFOR"). In 2005, the Maine Supreme Judicial Court remanded a Public Utilities Commission decision adopting a new AFOR because the "Commission failed to undertake even a cursory comparison of the local rates that would be set under an ordinary ROR proceeding" to the rates that would result from the AFOR plan as required by the legislature. *Office of Public Advocate, et al. v. Pub. Utils Comm'n.*, 866 A 2.d 851 (2005), at para. 9. The Court decision also addressed the Maine PUC's incorporation of a local rate increase to offset decreases in Verizon's access charges. *Id.*, at para. 39-43, fn 8. Verizon's assignment and allocation of costs are among the issues presently under investigation by the Maine Public Utilities Commission as a result of the Court's remand. *Investigation into New Alternative Form of Regulation for Verizon Maine Pursuant to 35-A M.R.S.A. § 9102-9103,* Maine Pubic Utilities Commission, Docket No. 2005-155.

[58] / *In the Matter of Petition of AT&T Inc. for Waiver of the Commission's Rules to Treat Certain Local Number Portability Costs as Exogenous Costs Under Section 61.45(d),* FCC CC Docket No. 95-116, *Order*, July 10, 2006.

48. Whether based on federal or state regulation, consumers pick up the tab for excessive rates and charges for regulated services. For example, ILECs advocate revenue recovery from the process of reforming intercarrier compensation through the subscriber line charge. Under the earlier "ICF" proposal, and under the recently submitted "Missoula Plan," the monthly subscriber line charge ("SLC") would increase. Under the original ICF plan the SLC would increase to $10.00 and $9.00, for non-rural and rural carriers, respectively.[59] Also, under the recently submitted "Missoula Plan," the industry proposes to impose a $10 subscriber line charge, which would balance the budget for intercarrier compensation reform by extracting monopoly profits from subscribers of regulated services.[60] The Commission should not consider *raising* the SLC until it has first assigned and allocated those costs away from regulated services that unregulated services should bear. Only then can the Commission determine which costs should be borne by consumers.

49. The Commission has stated that:

> State Consumer Advocates argue that the need to assign costs among all services using the loop will become even more important as incumbent LEC networks are engineered to deliver a variety of integrated services. … We conclude instead that as more services are offered over a single loop, cost allocations are likely to become more arbitrary and thus less reasonable.[61]

[59] / *In the Matter of Developing a Unified Intercarrier Compensation Regime*, CC Docket No. 01-92, Comments of the New Jersey Division of the Ratepayer Advocate, May 23, 2005, at 8, citing, *Cost Review Proceeding for Residential and Single-Line Business Subscriber Line Charge (SLC) Caps, Access Charge Reform*, CC Docket No. 96-262, *Order*, Rel. June 5, 2002, at para. 4; *CALLS Order*, at para. 85; *FNPRM* , at para. 42.

[60] / FCC Public Notice, "Comment Sought on Missoula Intercarrier Compensation Reform Plan," CC Docket No. 01-92, DA 06-1510, July 25, 2006.

[61] / *Broadband Sharing Order*, at fn 434.

I respectively disagree with the Commission's reluctance to address the allocation of the local loop. The following excerpt from the New Jersey Rate Counsel's comments opposing BellSouth's forbearance petition explains the need for the Commission to allocate the local loop fairly between regulated and unregulated services:

> Unless and until the Commission updates and revises the separations process, rate caps at the federal and state level cannot be considered just and reasonable. The fact that rates may not increase is not sufficient evidence that they are reasonable. The existing jurisdictional split of costs is based on a network of the past. If a fair share of the common network were allocated to the interstate jurisdiction, based on decisions such as the treatment of DSL and broadband services, state costs would decline and state rate caps should similarly decline. … With the shifting of costs to the interstate jurisdiction, state rate caps should decline, and, furthermore, re-initialization is necessary at state and federal levels.[62]

50. BellSouth's chief argument (that the prevalence of price cap systems throughout the states it serves and for its interstate operations obviates the need for cost data and reporting) suffers from a serious deficiency, as well as from a lack of empirical support. *Theoretically*, the purpose of price cap regulation is to yield rates that would exist in an effectively competitive market. However, *in reality*, price cap systems differ (with varying productivity factors, basket designations, rules for price changes, etc.), which is evidence of the fact that there is no "perfect" price cap system. Instead, any particular price cap system corresponds with the regulators' best efforts to design a mechanism that will create the proper incentives for investment and yield just and reasonable rates.

51. It is not surprising that as BellSouth successfully enters new lines of business and continues to earn supracompetitive profits from its special access services, it would urge

[62] / *Petition of BellSouth Telecommunications, Inc. for Forbearance Under 47 U.S.C.§ 160 from Enforcement of Certain of the Commission's Cost Assignment Rules*, WC Docket No. 05-342, Initial Comments of the New Jersey Division of the Ratepayer Advocate, January 23, 2006, at 10.

the Commission to eliminate the tools that would allow regulatory oversight of BellSouth's market practices and market power.

52. BellSouth also contends that the Commission should grant BellSouth forbearance from the Part 36 separations rules because of technological change and the existence of price cap regulation. BellSouth asserts that when both federal and state regulators adopted price cap regulation, there was no longer a need for a separations process. In further support of its position, BellSouth refers to the fact that – based on the recommendation of the Federal-State Separations Joint Board – the Commission adopted an interim freeze on jurisdictional separations rules effective July 1, 2001. Throughout its petition, BellSouth attempts to show that the "cost assignment exercise" is no longer relevant to fulfilling the original purpose of the cost assignment rules, which provided a framework established to ensure just and reasonable rates. BellSouth argues that even if the cost assignment rules are vaguely beneficial to "some broader array of evolving goal," their relationship to the original goals for which they were developed is "weak or remote."[63]

53. Contrary to BellSouth's assertion, absent a comprehensive assessment of BellSouth's costs and revenues, neither the Commission nor state public utility commissions can determine whether rate caps are just and reasonable. Jurisdictional allocation is long overdue for correction. Until and unless the Commission corrects its cost accounting rules, interstate and state rate caps cannot be considered just and reasonable.

[63] / BellSouth Petition, at 9.

Separations and cost allocation rules continue to be relevant because competition does not yet constrain ILECs' market power.

54. Another myth is that separations and cost allocation rules are irrelevant in today's purportedly competitive environment. One proponent of this theme stated: "[i]n a market where all services – interstate, intrastate, wireline, wireless, local, long distance, basic, and enhanced – are competitively disciplined, regulatory cost allocation requirements such as the separations rules are not only unnecessary to protect ratepayers, but destructive of true competition."[64] ILECs argue that separations and cost allocation rules are irrelevant in today's purportedly competitive environment. According to them, the market place yields efficient, competitively established rates, and, therefore, cost accounting is an unnecessary burden on industry and regulators. For example, Qwest stated earlier this year, "[d]etailed separations/cost allocation rules and competition are basically incompatible -- because cost allocation has little or no affect (sic) on prices in a competitive environment."[65]

55. Two fundamental fallacies undermine this oft-repeated Bell rationale for abandoning cost studies. First, competitive forces that constrain Bells' market power do not yet exist.[66] Second, even in competitive markets, firms track costs.

56. Bells' contention that competition adequately constrains Bells' market power, rendering cost allocation rules obsolete is not persuasive because competition does not

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[64] / *FNPRM*, at note 84, citing *BellSouth Cost Assignment Forbearance Petition,* WC Docket No. 05-342, Verizon Comments at 6-7.

[65] / FCC CC Docket No. 80-286, Qwest *ex parte*, April 27, 2006, at 6.

[66] / For further discussion of this point, see *In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, FCC WC Docket No. 06-74, sponsored declaration of Susan M. Baldwin and Sarah M. Bosley on behalf of the New Jersey Division of the Ratepayer Advocate, filed June 5, 2006 ("Baldwin/Bosley Declaration WC Docket No. 06-74").

yet constrain Bells' regulated services, and, indeed, likely does not yet constrain many of the Bells' unregulated services.[67]

57. Furthermore, rational suppliers rely on cost data to support strategic development and pricing. In a competitive market, suppliers typically track costs to support strategic marketing, sales, and development: those products that show little promise of covering their costs may be abandoned and those products for which key variables (such as consumer demand and revenues) are favorable relative to the associated costs will be pursued more actively.[68] Even a monopolist seeks information about average and marginal costs in order to maximize profits. As one economics textbook states, "a profit-maximizing monopolist produces that quantity for which marginal revenue is equal to

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[67] / Although the Commission determined that wireline broadband is an information service, the telco-cable duopoly does not provide sufficient competition to protect consumers from supracompetitive rates, service quality deterioration, and excessive control by telcos and cables of consumers' "information pipes." In a dissenting statement accompanying the Commission's Order approving the division of Adelphia assets between Time Warner and Comcast, Commissioner Copps states: "I am worried that this decision tightens the grip that cable companies share with telephone companies over our nation's broadband access. FCC data show that these two industries control some 98 percent of the broadband market. Despite this, the majority's Order goes on at length about the supposedly competitive broadband market. Indeed, the competitive picture the majority spins is at odds with too many other reports. A few weeks ago, the Congressional Research Service characterized the broadband market as a "cable and telephone duopoly." Dissenting Statement of Commissioner Michael J. Copps, Re: *Applications for Consent to the Assignment and/or Transfer of Control of Licenses; Adelphia Communications Corporation (and subsidiaries, debtors-in-possession), Assignors, to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and subsidiaries, debtors-in-possession), Assignors and Transferors, to Comcast Corporation (subsidiaries), Assignees and Transferees; Comcast Corporation, Transferor, to Time Warner, Inc., Transferee; Time Warner In., Transferor to Comcast Corporation, Transferee, Memorandum Opinion and Order*, FCC MB Docket No. 05-192, July 13, 2006; *See,* also, Statement of Commissioner Michael J. Copps, Re: *Amendment of Part 15 Regarding New Requirements and Measurement Guidelines for Access Broadband over Power Line; Carrier Current Systems Including Broadband over Power Line Systems, Memorandum Opinion and Order*, August 3, 2006.

[68] / Of course, if a supplier in a competitive market decides affirmatively to cross-subsidize its products (for example, by setting a low price for a digital camera and a high price for printing digital photos), there are no adverse implications for consumers, competitors, and the industry structure. By contrast, in telecommunications markets, ILECs' supply of competitive and noncompetitive products creates specific concerns, for which regulators require cost accounting data.

marginal cost."[69] Also, "[a]lthough a monopoly may earn positive profits in the long run, the size of such profits will depend on the relationship between the monopolist's average costs and the demand for its product."[70]

58. The complexity of assigning and allocating costs does not mean that industries in competitive markets are ignorant of such costs. Furthermore, regulators' need for data outweigh any purported burden to BellSouth. As has been previously observed by a consumer advocate:

> However, if BellSouth operated in a competitive market, it is likely that costs and revenues for products and services would need to be tracked, gathered, and reported to distinguish between profitable services and non-profitable ones. Assignments of various costs (or "charge-backs") would need to occur so that BellSouth could spend money prudently on those services for which expected revenues exceeded expected costs. In other words, some of the "cumbersome" book-keeping processes would be necessary for any company seeking to focus on financially lucrative products and to discontinue the less profitable ones. The fact that cost allocation is difficult does not render it useless.
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> Furthermore, the burden that Bellsouth describes is outweighed by the benefit to the regulator of having access to data. There is a serious asymmetry between the information to which regulators have access and the information that BellSouth possesses. Granting BellSouth's petition would exacerbate this asymmetry to the detriment of consumer protection.[71]

59. Contrary to the unfounded Bell myth, Bells' dominant position has not yet diminished sufficiently to enable regulators to rely on competitive forces to yield economically efficient rates. For the reasons set forth in my Affidavit and in the

[69] / Walter Nicholoson, *Microeconomic Theory, Basic Principles and Extensions,* Seventh Edition, 1998, at 548.

[70] / *Id*., at 550, cite omitted.

[71] / *Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. §160 from Enforcement of Certain of the Commission's Cost Assignment Rules*, Initial Comments of the New Jersey Division of the Ratepayer Advocate, January 23, 2006, at 13-14.

comments submitted by the New Jersey Rate Counsel, the Commission should reject BellSouth's petition for forbearance.

Consumers have expressed a longstanding concern about the outdated separations factor.

60. Consumer advocates have repeatedly raised concerns about the impact on consumers of the outdated separations factor, the mismatch of DSL revenues and costs, the implications of BOCs' pursuit of new lines of business, and the anticompetitive implications of bundled offerings.[72]

61. In a recent submission to the Commission, the Rate Counsel discussed states' ratemaking authority, and stated, among other things:

> There is nothing in Section 271 that evidences that Congress's intent was to alter Section 2(b) of the Act and otherwise permit the FCC to set intrastate rates …. The Supreme Court has clearly spoken that Section 2(b) fences off intrastate telecommunications matters from FCC regulation. See *Louisiana Public Service Commission. V. FCC*, 476 U.S. 355, 374 (1986). Any purported construction of the Act to permit or allow the FCC to regulate intrastate rates is misplaced and exceeds its authority.[73]

62. Based on the prolonged inaction by the Commission on this critical aspect of ratemaking, it is appropriate and necessary for states to consider independently the proper assignment and allocation of common network plant to the intrastate jurisdiction. This

[72] / See, for example, *Petition of BellSouth Telecommunications, Inc. for Forbearance Under 47 U.S.C.§ 160 from Enforcement of Certain of the Commission's Cost Assignment Rules, WC Docket No. 05-342*, Initial Comments of the New Jersey Division of the Ratepayer Advocate, January 23, 2006, at 10, 12, 22-23. *See*, also Reply Comments of the New Jersey Division of the Ratepayer Advocate, February 10, 2006, at pages 2 to 3; Reply Comments of the New Jersey Division of the Ratepayer Advocate, *In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-High-Cost Universal Service Support*, WC Docket No. 05-337, May 26, 2006, at 29; Reply Comments of the New Jersey Division of the Ratepayer Advocate, *In the Matter of Transfer of Control Filed by SBC Communications Inc. and AT&T Corp*., FCC WC Docket No. 05-65, May 10, 2005, at 18-19.

[73] / *In the Matter of Georgia Public Service Commission Petition for Declaratory Ruling and Confirmation of Just and Reasonableness of Established Rates*, WC Docket No. 06-90, Comments of the New Jersey Division of the Ratepayer Advocate, May 19, 2006, at 3.

state-based analysis is essential to support state regulators' independent duty to assess whether rates are just and reasonable. As I discuss earlier in my affidavit, the Commission should clarify that states have the authority to render independent decisions regarding cost assignment and cost allocation.

The extension of the freeze provides stability for the industry but results in excessive intrastate costs and rates.

63. The separations freeze may provide regulatory certainty for the industry, but it perpetuates a situation whereby interstate and intrastate rates are distorted (and noncompetitive services likely subsidize unregulated services). In comments filed recently with the Commission in its investigation of high cost universal service support, the Rate Counsel stated:

> The Commission's recent decision to extend the separations freeze continues the over-allocation of costs to intrastate and non-competitive services and the under-allocation of costs to ILECs' competitive and interstate services. This decision underscores the compelling need to assess ILECs' costs comprehensively to ensure that basic services and high cost funds are not subsidizing ILECs' entry into video, data, and other services. If the Commission pursues some variation of NASUCA's proposal to examine revenues, the Commission should consider all revenues that carriers derive as a result of their investment in a common network platform or should allocate away the portion of the network costs that ILECs incur to deploy diverse video, data, and non-traditional telecommunications services.[74]

64. A comprehensive assessment of the assignment and allocation of costs is long overdue and is critical to inform the Commission's deliberations in the separations proceeding, as well as in the special access, intercarrier compensation, and universal

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[74]/ *In the Matter of Federal-State Joint Board on Universal Service*, CC Docket No. 96-45; *High-Cost Universal Service Support*, WC Docket No. 05-337, Reply Comments of the New Jersey Division of the Ratepayer Advocate, submitted May 26, 2006, at 29, citing *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Order and Further Notice of Proposed Rulemaking*, released May 16, 2006.

service proceedings. The regulatory certainty that the Commission's recent decision provides the industry comes at great expense for consumers.[75] Although the principles of *Smith v. Illinois* may not require "extreme precision,"[76] the separations freeze institutionalizes a gross imprecision.

[75]/ The Commission states that the extension of the time freeze "will provide significant stability to the jurisdictional separations process" and that "[m]aintaining the stability and regulatory certainty of the freeze will allow carriers to make investment decisions without fear that a reversion to the earlier rules would create radically different cost recovery requirements than they would currently expect." *FNPRM*, at para. 22.

[76]/ *Id.*, at fn. 52.

IV. IMPLICATIONS OF BELLS' PURSUIT OF UNREGULATED LINES OF BUSINESS

The Bells' pursuit of new unregulated ventures underscores the need to ensure that the Part 64 rules exclude the proper share of costs from their regulated operations.

65. Acquiring its archrival has enabled SBC to silence an otherwise likely dissenting voice in this proceeding but has heightened the concerns that legacy AT&T expressed two years ago. Legacy AT&T's explanation of the need for regulatory accounting and reporting applies even more in this era of industry consolidation and concentration than when, as a competitive local exchange carrier ("CLEC"), it competed with the Bells:[77]

> Regulatory accounting and reporting requirements are more important today than ever before. New technologies and deregulation have allowed incumbent LECs increasingly to enter competitive markets – e.g., long-distance, wireless and broadband markets – creating additional opportunities for incumbents to abuse their control over the bottleneck local facilities that are necessary inputs in those other markets. And it is only through detailed and strictly enforced accounting and reporting requirements, accompanied by rigorous audits, that the Commission and state regulators can enforce prohibitions against anticompetitive abuses of market power.[78]

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[77]/ The Commission approved SBC's acquisition of legacy AT&T and Verizon's acquisition of MCI. *In the Matter of SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-65, *Memorandum Opinion and Order*, Rel. November 17, 2005 ("SBC/AT&T Merger Order"); *In the Matter of Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-75, *Memorandum Opinion and Order*, Rel. November 17, 2005 ("Verizon/MCI Merger Order"). Both transactions are presently under review by the federal district court. United States of America v. SBC Communications Inc. *et al*, 1:05-cv-2102, United States of America v. Verizon Communications Inc. et al, 1:05-cv-2103. NASUCA has been granted intervention in the case now pending before the United States District Court for the District of Columbia and the New Jersey Rate Counsel is participating as an *amicus curiae.*

[78] / *Federal-State Joint Conference on Accounting Issues*, WC Docket No. 02-269, *2000 Biennial Regulatory Review - Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase II*, CC Docket No. 00-199, *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Local Competition and Broadband Reporting*, CC Docket No. 99-301, Comments of legacy AT&T Corp., January 30, 2004, at 5.

66. Bells are relegating POTS and other traditional services to the back seat while they pursue new lines of business and focus on their most profitable customers. Furthermore, as Table 1 shows, Bells are relying on the relatively stable, and clearly substantial, stream of almost $100 billion in yearly revenues from their regulated services to provide a nearly risk-free source of funds for pursuing unregulated services.

Table 1

Steady Flow of Revenues From Non-Competitive Regulated Services
Supports Investment in Nonregulated Services
(Revenues Reported as Regulated: Interstate and Intrastate Combined)
(000 omitted)

	2000	2001	2002	2003	2004	2005
AT&T	$38,361,005	$38,186,278	$36,088,753	$34,538,551	$34,436,917	$34,261,646
BellSouth	$17,602,103	$18,029,818	$17,196,130	$17,241,656	$16,717,860	$16,738,230
Qwest	$11,461,515	$11,745,064	$11,170,836	$10,694,952	$10,248,422	$9,925,754
Verizon	$41,270,356	$40,486,766	$37,908,282	$37,276,875	$36,512,791	$35,651,621
Bell Total	$108,694,979	$108,447,926	$102,364,001	$99,752,034	$97,915,990	$96,577,251

Source: *Regulated/Nonregulated Revenues and Costs Report (In Current Corporate Structures)* , based on ARMIS Report 43-01, Table I. Accessed 7/10/2006.

Outdated cost allocation rules do not adequately address the Bells' pursuit of DSL, fiber-to-the-premises, fiber-to-the-node, VoIP, packet switched services, and long distance services, and therefore fail to protect consumers properly from excessive rates.

67. The Commission's delay in correcting the outdated cost allocation rules and states' reluctance to exercise their independent judgment and expertise harm consumers in several significant respects. First, although consumers' historic funding of the Bells' investment in a common, ubiquitous network provides the Bells with a unique and invaluable resource to leverage as they enter new areas such as fiber to the home, fiber to the node, video offerings, IPTV, broadband telephone, and integrated service offerings, the Bells do not compensate consumers for the financial contribution that consumers of

basic services have made toward these efforts. Second, the Bells' pursuit of new, unregulated lines of business divert their attention and resources away from basic local exchange service.

The Commission's *Broadband Sharing Order*.

68. In its *Broadband Sharing Order*, issued approximately a year ago, the Commission stated:

> [W]e address cost allocation issues raised by our decision to allow incumbent LECs to enter into non-common carriage arrangements with affiliated and unaffiliated ISPs for the provision of wireline broadband Internet access transmission using facilities that are also used for provision of regulated telecommunications services. Specifically, we address whether we should require incumbent LECs subject to our part 64 cost allocation rules to classify that activity as a regulated activity, as opposed to a nonregulated activity, under our part 64 cost allocation rules. We conclude that incumbent LECs should classify this non-common carrier activity as a regulated activity under those rules and that this accounting treatment is consistent with section 254(k) of the Act.[79]

The Commission further stated:

> In this Order, we allow the non-common carrier provision of wireline broadband Internet access transmission that we previously have treated as regulated, interstate special access service, but we do not preemptively deregulate any service currently regulated by any state. Therefore, as specified in section 32.23 of our rules, the provision of this transmission is to be classified as a regulated activity under part 64 "until such time as the Commission decides otherwise." We do not "decide otherwise" at this time because we find that the costs of changing the federal accounting classification of the costs underlying this transmission would outweigh any potential benefits and that section 254(k) of the Act does not mandate such a change.[80]

[79]/ *Broadband Sharing Order*, at para. 128.

[80]/ *Id.*, at para. 130, citing *GTE DSL Order*, 13 FCC Rcd at 22474-83, paras. 16-32 (finding that GTE's ADSL service is an interstate special access service that should be federally tariffed); GTE DSL Reconsideration Order, 17 FCC Rcd at 27411-12, para. 9 (stating that, in some circumstances, vADSL services may be appropriately tariffed as interstate services); 47 C.F.R. § 32.23(a); see Joint Cost Order, 2 FCC Rcd at 1308-09, para. 79 (stating intent to address on a case-by-case basis the accounting treatment to be accorded activities deregulated only in the interstate jurisdiction).

The Commission also stated:

> Based on the current record, we find that this reduction in incentives diminishes the need for incumbent LECs to apply detailed and burdensome procedures to exclude the costs of providing broadband Internet access transmission from their regulated costs. A nonregulated classification therefore would generate at most marginal benefits.[81]

69. As I demonstrate below, the Commission's reasoning in last year's *Broadband Sharing Order* contributes to its neglect of its responsibility to ensure that the rates that consumers pay for basic service and the quality of basic service are just and reasonable.

70. Table 2 estimates the revenues that the four Bells derive from their popular DSL products, based on the prices they post on their web sites, and the demand that they report in their annual reports. As Table 2 shows, Bells derive at least $3 billion annually and as much as $12 billion from this unregulated service.

Table 2

Estimates of Bells' 2005 DSL Revenues

	Number of Connections	Monthly Rates: Lowest Price	Monthly Rates: Highest Price	Estimated 2005 Revenues: Low Estimate	Estimated 2005 Revenues: High Estimate
AT&T	6,921,000	$12.99	$54.99	$1,078,845,480	$4,567,029,480
BellSouth	2,882,000	$24.95	$109.95	$862,870,800	$3,802,510,800
Qwest	1,480,000	$26.99	$62.33	$479,342,400	$1,106,980,800
Verizon	5,144,000	$14.99	$39.95	$925,302,720	$2,466,033,600
Total RBOCs	16,427,000			$3,346,361,400	$11,942,554,680

Note: The Low Estimate is calculated by multiplying the number of DSL connections by the lowest advertised monthly rate for DSL service, times 12. The High Estimate is calculated by multiplying the number of DSL connections by the highest advertised monthly rate, times 12.

Sources: Websites for AT&T, BellSouth, Qwest, and Verizon, visited 8/1/2006.

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[81]/ *Id.*, at para. 133.

71. Furthermore, as demand for this service has grown, so has the Bells' stream of revenues. Table 3 shows the rapid growth in consumer demand for each of the Bells' DSL service.

Table 3

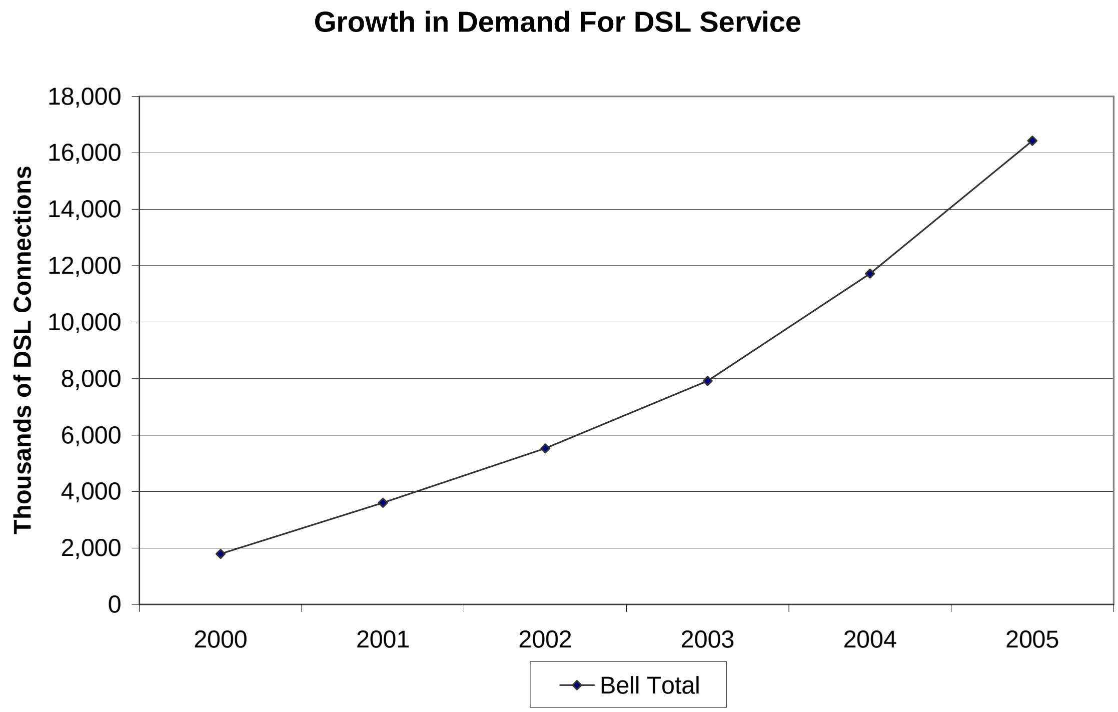
Demand for Bells' DSL Continues to Increase Dramatically
(DSL connections in thousands)

	2000	2001	2002	2003	2004	2005
AT&T	767	1,333	2,199	3,515	5,104	6,921
BellSouth	215	621	1,021	1,462	2,096	2,882
Qwest	271	448	510	638	1,037	1,480
Verizon	540	1,200	1,800	2,300	3,485	5,144
Bell Total	1,793	3,602	5,530	7,915	11,722	16,427
Annual Growth Rate		101%	54%	43%	48%	40%

Sources: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; BellSouth 2003 Annual Report; page 30; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; Qwest 2001 Annual Report, page 45; Qwest 2002 Annual Report, page 37; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon Q4 2002 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13.

Figure 2 shows that demand in 2000 was less than 2 million and grew to more than 16 million lines in 2005.

Figure 2[82]



Customers of intrastate regulated services should not subsidize Bells' entry into new lines of business and/or into old lines of business that are newly deregulated.

72. ILECs are actively pursuing new lines of business, the cost of which should not be recovered from customers of basic local telephone service. As the *Glide Path II Paper* states:

> Many telecommunications carriers today offer a variety of competitive and semi-competitive services. Separations applies only to costs that are not excluded under Part 64 of FCC rules, but those rules have not been revised since before Congress mandated local exchange competition. This

82 / Sources: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; BellSouth 2003 Annual Report; page 30; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; Qwest 2001 Annual Report, page 45; Qwest 2002 Annual Report, page 37; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon Q4 2002 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13.

> may suggest that new rules are needed to exclude from separations some new classes of competitive facilities, expenses, and revenues.[83]

73. The Bells' increasing focus on broadband and video increases the incentive for cross-subsidization of new ventures with monopoly revenues. In 2000, DSL connections made up only 1% of the total connections, where total connections are defined as the sum of switched access lines and DSL connections.[84] By 2005, this "DSL ratio" reached 12%. In Appendix C, I compute a rough projection of DSL subscribership through 2010, based on DSL demand trends between 2000 and 2005. Assuming, for example, that the annual growth decreases by five percent each year, DSL demand would be approximately 50 million in 2010. The ultimate penetration of DSL depends on Bell's deployment plans, customer preference for alternative technologies (*e.g.*, cable modem),[85] and the Bells' success in encouraging DSL customers to migrate to the Bells' new fiber-based alternatives. Bells' video marketing plans cast doubt on their commitment to provide reliable, affordable "traditional" local services, and also justify careful accounting of their costs and revenues.

74. Furthermore, DSL is likely the Bell's stepping stone to other platforms to support their entry into video services, which they seek to offer in "competition" with cable

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[83] / *Glide Path II Paper*, at 6.

[84] / In Appendix C, I include three tables and a figure, which summarize data demonstrating the changing pattern of consumer demand. Table C-1 shows that Bells' sales of additional residential lines declined by approximately 5 million between 2002 and 2005. Figure C-2 shows the gradual growth in addition lines between 1988 and 2001, following by a steady decline in demand for additional lines. Table C-3 in Appendix C provides overall demand data for switched access lines, residential access lines and DSL connections. Table C-4 provides a projection of DSL subscribership through 2010.

[85] / According to the FCC's latest high speed services data, consumer DSL subscriptions grew by 5.7 million lines in 2005 compared to a growth of 4.2 million lines for consumer cable subscriptions. The cable industry percentage of high-speed lines dropped 3.5%, while the DSL share of high-speed lines grew 3.3% to reach 40.5%. FCC, Industry Analysis and Technology Division, Wireline Competition Bureau, *High-Speed Services for Internet Access: Status as of December 31, 2005*, July 2006.

companies.[86] By locking in customers to DSL-based services, the Bells can then more easily encourage the same customers to migrate to higher-revenue fiber-based video offerings. Proper cost accounting is essential to ensure that Bells compensate customers of local intrastate regulated services adequately for the invaluable use of the DSL stepping stone.

The assignment of costs between regulated and nonregulated activities merits particular scrutiny, particularly because ILECs are using common network plant and operations to support their pursuit of nonregulated services.

75. The Commission's rules, albeit insufficient in detail, are unambiguous in their objective. The rules state: "A telecommunications carrier may not use services that are not competitive to subsidize services subject to competition."[87] Although the Commission particularly seeks comment on separations between inter- and intrastate

[86] / The purported "competition" is negligible since consumers confront a cable-telco duopoly. A recent Congressional Research Report concluded: "With only limited alternatives to the cable and telephone broadband duopoly for the foreseeable future, and with the cable and telephone companies both pursuing largely the same business plan, the broadband providers might have both the incentive and the ability to exploit their control over access to end users to restrict competition (and the innovation it might bring) and harm consumers." Charles B. Goldfarb, *Access to Broadband Networks*, Congressional Research Service, CRS Report for Congress, Order Code RL33496, June 29, 2006, at 17. Commissioner Copps cited this conclusion in his dissent in the recent Order approving the cable deal essentially splitting Adelphia assets among Time Warner and Comcast as well as transferring current licenses between the two cable giants. Commissioner Copps states: "I am worried that this decision tightens the grip that cable companies share with telephone companies over our nation's broadband access. FCC data show that these two industries control some 98 percent of the broadband market. Despite this, the majority's Order goes on at length about the supposedly competitive broadband market. Indeed, the competitive picture the majority spins is at odds with too many other reports. A few weeks ago, the Congressional Research Service characterized the broadband market as a "cable and telephone duopoly." Dissenting Statement of Commissioner Michael J. Copps, Re: *Applications for Consent to the Assignment and/or Transfer of Control of Licenses; Adelphia Communications Corporation (and subsidiaries, debtors-in-possession), Assignors, to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and subsidiaries, debtors-in-possession), Assignors and Transferors, to Comcast Corporation (subsidiaries), Assignees and Transferees; Comcast Corporation, Transferor, to Time Warner, Inc., Transferee; Time Warner In., Transferor to Comcast Corporation, Transferee, Memorandum Opinion and Order*, FCC MB Docket No. 05-192, July 13, 2006; *See*, also, Statement of Commissioner Michael J. Copps, Re: *Amendment of Part 15 Regarding New Requirements and Measurement Guidelines for Access Broadband over Power Line; Carrier Current Systems Including Broadband over Power Line Systems, Memorandum Opinion and Order*, August 3, 2006.

[87] / 47 U.S.C.§ 254(k).

jurisdictions, the Commission should devote equal if not more attention to the assignment of costs between regulated and nonregulated services. Whether they pay through higher *interstate* subscriber line charges or inflated *intrastate* rates, consumers foot the bill for costs that are erroneously allocated to regulated services.[88]

76. Table 4 summarizes the Bells' reporting of regulated and unregulated revenues.

Table 4

Split of Bells' Revenue Between
Regulated Services And Nonregulated Services
(000 omitted)

		2000	2001	2002	2003	2004	2005	% Change 2000-2005
AT&T	Regulated	$35,501,672	$35,064,614	$33,516,869	$31,784,887	$31,221,877	$30,930,585	-13%
	Non Regulated	$2,859,333	$3,121,664	$2,571,884	$2,753,664	$3,215,040	$3,331,061	16%
BellSouth	Regulated	$16,806,614	$17,291,302	$16,510,058	$16,454,861	$15,851,705	$15,614,372	-7%
	Non Regulated	$795,489	$738,516	$686,072	$786,795	$866,155	$1,123,858	41%
Qwest	Regulated	$10,869,399	$11,119,178	$10,645,195	$10,129,141	$9,768,821	$9,442,070	-13%
	Non Regulated	$592,116	$625,886	$525,641	$565,811	$479,601	$483,684	-18%
Verizon	Regulated	$38,768,193	$38,142,714	$35,782,152	$35,215,469	$34,536,632	$33,526,878	-14%
	Non Regulated	$2,502,163	$2,344,052	$2,126,130	$2,061,406	$1,976,159	$2,124,743	-15%
Bell Total	Regulated	$101,945,878	$101,617,808	$96,454,274	$93,584,358	$91,379,035	$89,513,905	-12%
	Non Regulated	$6,749,101	$6,830,118	$5,909,727	$6,167,676	$6,536,955	$7,063,346	5%

Source: *Regulated/Nonregulated Revenues and Costs Report (In Current Corporate Structures)* , based on ARMIS Report 43-01, Table I. Accessed 7/10/2006.

77. As Table 4 shows, from 2000 to 2005, the Bell total for regulated revenues decreased by 12 percent and the Bell total for nonregulated revenues increased by 5 percent.[89] As Table 3 and Figure 2 show, during the same time period, the number of DSL subscribers has grown by over 800 percent. At a minimum, the Commission should request detailed information about the products and services that the Bells include in the

[88] / Furthermore, to the extent that purportedly "competitive" services have been unregulated, consumers, of course, pay monopoly-based prices for unregulated services.

[89] / The data are reported in ARMIS Report 43-01.

unregulated category, including, among others, their accounting treatment of new fiber-based offerings.[90]

78. There is substantial evidence of the Bells' strategy to pursue new lines of business and their simultaneous neglect of local service:

- Verizon plans to spin off its yellow pages division to focus on wireless, broadband, and television businesses.[91]

- The Bells are actively pursuing "triple play" business strategies where they seek to supply voice, data, and video to customers throughout their regions. Appendix D to my affidavit reproduces selected press releases about the Bells' entry into the video services market.

- According to the senior executive vice president for corporate development of AT&T, James Kahan, until as recently as 1999, the telecommunications industry was "voice-centric" and since then has become "data-centric," with "an evolution toward IPTV [Internet Protocol TV] services to provide video over IP networks."[92] Mr. Kahan also touted as one of the benefits of the proposed merger with BellSouth that BellSouth customers would have access to IPTV much more quickly.[93] AT&T recently announced that it intends to invest $247 million in Kansas as part of the first phase of fiber network upgrades that will ultimately support high-speed Internet access, IP-based video, and VoIP services. AT&T indicates that the investment, which is part of a planned investment of $4.6 billion throughout its territory, is a consequence of state legislation that allows new video entrants to seek state-

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[90] / For example, BellSouth Florida states in its notes in its ARMIS Report 43-03 that the "increase [in nonregulated operating revenue] is primarily due to growth in its retail DSL service." ARMIS Joint Cost Report, BellSouth Florida, Year 2005, Table I – Regulated/Nonregulated Data, Footnote 1 and Row 5280. By contrast, Verizon New England – Massachusetts, Qwest – Washington, and AT&T – Kansas do not include similar notes in their ARMIS reports.

[91] / "Verizon Plans to Spin Off Yellow Pages Unit," Ken Belson, *New York Times*, July 8, 2006, B-3. *See also*, Verizon Form 8-K, filed July 7, 2006.

[92]/ *In the Matter of BellSouth Corporation and AT&T Inc. Application Pursuant to Section 214 of the Communications Act of 1934 and Section 63.04 of the Commission's Rules for Consent to the Transfer of Control of Bellsouth Corporation to AT&T Inc*, WC Docket No. 06-74, Application for Consent of Transfer of Control, filed March 31, 2006, Attachment 1 to the Application, "Description of Transaction, Public Interest Showing and Related Demonstration," ("Public Interest Statement"), declaration in support of the merger submitted by James S. Kahan (Senior Executive Vice President – Corporate Development, AT&T), at para. 6.

[93] / *Id.*, at 13-15.

issued franchises rather than being required to negotiate individual agreements with local governments.[94]

- There is evidence of Bells' service quality deteriorating, with customers living in rural areas and customers who do not seek bundled offerings, most vulnerable.[95]

- Section VII discusses the trends in Bells' sales of bundled services, and the implications of those increasing sales for cost accounting rules.

The following section highlights various statements that the Bells have made recently to investors about their marketing and sales of new services.

The Bells' annual reports emphasize their pursuit of new services.

Overview

79. In annual reports to their shareholders, Verizon, AT&T, and BellSouth boast of extensive investments in fiber-optics and other advanced technologies.[96] The companies detail the rising percentage of homes passed by fiber, and the ever-increasing speed of broadband technologies. Substantial investment and rising revenues, as well as the

[94] / "AT&T Plans $247M Upgrade in Kansas," *TR Daily*, May 30, 2006.

[95] / The New Hampshire Public Utilities Commission and the Maine Public Utilities Commission are among the state regulators currently examining service quality and the need for economic incentives to ensure that customers receive local services at acceptable levels of service quality. *Verizon New Hampshire Alternative Regulation Plan*, New Hampshire Public Utilities Commission Docket No. DT 06-072, *Investigation into New Alternative Form of Regulation for Verizon Maine Pursuant too 35-A M.R.S.A. § 9102-9103*, Maine Pubic Utilities Commission, Docket No. 2005-155.

In areas of Kansas, a state recently selected by AT&T for a roll-out of an IPTV trial, service quality has declined in recent years, as illustrated by average installation intervals and out-of-service repair intervals. In the MSAs of Kansas, the average installation interval increased from 0.7 days in 2000 to 2.5 days in 2005. In non-MSA areas, the metric increased similarly, from 0.7 days in 2000 to 2.1 days in 2005. FCC ARMIS Report 43-05, The ARMIS Service Quality Report, Table II, Installation and Repair Intervals (Local Service), Row 134, Data Run Date: 6/2/2006. Repair intervals increased between 2000 and 2005, as well. In MSAs, the average initial repair interval increased from 16 hours in 2000 to over 29 hours in 2004 and 2005. In non-MSA areas the repair interval increased from 13.7 hours to 24.6 hours. FCC ARMIS Report 43-05, The ARMIS Service Quality Report, Table II, Installation and Repair Intervals (Local Service), Row 145, Data Run Date: 6/2/2006. The carriers' promises of state-of-the-art IPTV and other new services do not justify the deterioration of basic telephone service quality.

[96] / In sharp contrast with the annual reports of AT&T, BellSouth, and Verizon, Qwest's annual report is silent about any planned investment in advanced technology. Qwest 2005 Annual Report.

companies' own statements, indicate that Bells are devoting increasing levels of resources to advanced, nonregulated services, rather than traditional wireline voice service. The Commission should seek information from Bells about how they account for the costs of these new telecommunications services and fiber upgrades.

Verizon's plans

80. Investment is a major topic in Verizon's 2005 annual report, reiterated at several points, as the following excerpts demonstrate:

> Over the years, we have *invested steadily in fiber backbones, digital switching, and higher-bandwidth capabilities such as DSL*, which have given us a growing foothold in broadband. In 2005, we took another big step to transform this business by deploying a unique fiber architecture to the home that enables us to provide super-high speed Internet access and enter the video market. This fiber network now passes 3 million customers, with another 3 million targeted for 2006.[97]
>
> Our fiber network provides customers with blazing fast Internet connections and over 400 channels of 100 percent digital video.[98]
>
> We own and operate one of the most expansive end-to-end global Internet Protocol (IP) networks. This infrastructure includes over 270,000 domestic and 360,000 international route miles of fiber-optic cable, provides next-generation IP network services.[99]

81. Verizon explains to shareholders the negative effect of their major investment on share prices and yet justifies its plans to continue laying fiber-optics to homes in support of its advanced, nonregulated, "growth markets." Verizon states:

> Unfortunately, 2005 was a difficult year for Verizon's stock. Our total return for the year was down 22.2 percent. This is both disappointing and frustrating for us. Investors have told us that they are concerned with the effect of competition and technology substitution in our traditional business, *the heavy capital investment*

[97]/ Verizon 2005 Annual Report, page 2 (emphasis added).

[98]/ *Id.*, page 5.

[99]/ *Id.*

> *we're making in broadband*, and the potential uncertainty created in 2005 by the pending MCI transaction.[100]

Verizon further explains:

> In 2004, Verizon began rolling out our groundbreaking fiber network, featuring an advanced technology that uses fiber-optics instead of copper wire as the direct connection to homes and businesses. By the end of 2005, Verizon's fiber network passed 3 million homes and was deployed in close to 800 communities in more than half the states that we serve. We plan to pass an additional 3 million homes by the end of 2006, covering around 20 percent of our residential customer base.[101]

Verizon further states:

> Verizon's capital expenditures continue to be directed toward growth markets. High-speed wireless data (Evolution-Data Optimized, or EV-DO) services, replacement of copper access lines with fiber optics to the home, as well as expanded services to business markets are examples of areas of capital expenditures in support of these growth markets. In 2005, Verizon achieved targeted increased capital expenditures of $15,324 million compared to 2004 capital expenditures of $13,259 million in support of growth initiatives. Approximately 69% of 2005 capital expenditures related to growth initiatives.[102]

82. Verizon devoted 69% of its 2005 capital expenditures to "growth" services, but it is not alone in emphasizing new lines of business. AT&T and BellSouth are also chasing high-end telecommunications markets, and extol their substantial investment in DSL technology and fiber-optics to their investors. They describe their plans to upgrade services, allowing digital television, "super-highspeed broadband," and VoIP service.

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[100]/ *Id.*, page 3 (emphasis added).

[101] / *Id.*, pages 6-7.

[102] / *Id.*, page 14.

AT&T's plans

83. AT&T states to investors that it "leads the industry in deploying DSL broadband technology, with 7 million lines in service – more DSL lines than any other company in America."[103] AT&T also states:

> In June 2004, we announced key advances in developing a network capable of delivering a new generation of integrated digital television, super-highspeed broadband and VoIP services to our residential and small-business customers, referred to as Project Lightspeed… We expect to have the capability to offer service to approximately 18 million households by the end of 2008, as part of our initial deployment, and expect to spend approximately $4,400 [$4.4 billion] in network-related deployment costs and capital expenditures beginning in 2006 through 2008, as well as additional success-based customer activation capital expenditures.[104]

BellSouth's Plans[105]

84. BellSouth, similarly, emphasizes its new "fiber-rich" technology and new network capabilities in its annual report:

> At BellSouth, we're pushing fiber penetration deeper into our already fiber-rich network. Presently, approximately 50 percent of the households we serve are connected via fiber optic cable and short copper loops. Ultimately, this combination of fiber and copper will enable us to deliver bandwidth at speeds of 12 to 24 megabits per second and higher throughout our network.[106]

BellSouth further states:

> We are increasing the speed of our wireline network by building on the investments we have made over the past two decades. Our goal is to deliver more bandwidth, better security and quality of service to our consumer and business customers. Throughout the year, customers have migrated to higher speeds of service and, in 2005, we initiated faster DSL Internet service with speeds up to six

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[103] / AT&T 2005 Annual Report, page 10.

[104] / *Id.*, page 34.

[105] / If the AT&T/BellSouth merger is completed, the merged firm will be even more focused on advanced services. *See, e.g.,* paras 196-198, 235-241 of Baldwin/Bosley Declaration in WC Docket No. 06-74 for a discussion of the implication of this shift in focus for mass market consumers.

[106] / BellSouth 2005 Annual Report, page 3.

> megabits per second in certain markets. We also began testing speeds of up to 12 megabits per second on our network. Our test results are positive, and we are upgrading the network so that 50 percent of our households will have access to speeds of 12 to 24 megabits by the end of 2007. This translates into 70 percent of the households in our top 30 markets.[107]

> Approximately half the homes in the BellSouth region are expected to be within 5,000 feet of fiber and to be served by Gigabit Ethernet-fed IP aware DSL technology by December 31, 2007. This can be achieved at a reasonable economic cost due to the Company's history of fiber investment and deployment. At these short distances, data speeds of 12Mbps (single lines) and 24Mbps (two ""bonded" lines) are possible with ADSL2 technology, which is an evolution of DSL technology. With the completion of even more advanced standards in 2005, referred to as VDSL2, even higher speeds are expected to be possible at shorter distances in 2007.[108]

Bells' deployment of advanced technologies should bear a fair allocation of the cost of common plant and resources.

85. Presumably, Verizon, AT&T, and BellSouth do not make substantial investments unless they believe these investments will add to the bottom line. It is unclear, however, the degree to which the Bells rely on their regulated services and large customer base to provide the virtually risk-free source of revenues that enable them to embark in new, riskier areas. The companies' letters to shareholders show that nonregulated business segments are providing a large portion of their revenues. As Verizon points out, "growth businesses" have provided a significant boost to overall revenues in the last four years. Verizon further states its intention of "revenue transformation," focusing on nonregulated business units and describes its plans to devote more resources to advanced services, "rather than to traditional wireline voice services." Verizon states:

> Revenues were $75 billion in 2005, up 5.4 percent over 2004. In the last four years, we have expanded our revenue base by $8.6 billion *through our focus on growth businesses such as wireless, consumer broadband and high-speed*

[107] / *Id.*, page 17.

[108] / *Id.*, page 54.

> *business data products.* Leading the way was Verizon Wireless, which grew revenues by 16.8 percent – an extraordinary performance for a business with more than $30 billion in revenues.[109]

Verizon continues:

> Our emphasis is on revenue transformation, devoting more resources to higher growth markets such as wireless, wireline broadband connections, including digital subscriber lines (DSL) and fiber optics to the home (Verizon's FiOS data product), long distance and other data services as well as expanded services to business markets, rather than to traditional wireline voice services, where we have been experiencing access line losses. In 2005, revenues from these growth areas increased by 15% compared to 2004 and represent 58% of our total revenues, up from 53% of total revenues in 2004 and 47% in 2003.[110]

86. AT&T also anticipates that more of its revenue will come from nonregulated business segments, especially Project Lightspeed, AT&T's fiber-to-the home initiative:

> Over the next few years we expect an increasing percentage of our growth to come from: (1) data/broadband, through existing services, new services to be provided by our Project Lightspeed initiative and our acquisition of ATTC, and (2) Cingular's wireless service.[111]

AT&T also states:

> Our data services include DSL/Internet (broadband) as well as services to large businesses. At December 31, 2005, our data revenues represented approximately 30% of our consolidated revenues, and increased 18% from 2004. Our DSL lines continue to grow and were approximately 6.9 million at December 31, 2005 compared to 5.1 million at the end of 2004."[112]

109/ Verizon Annual Report, page 2 (emphasis added).

110 / *Id.*, page 14.

111 / AT&T Annual Report, page 34.

112 / *Id.*, page 34.

Impact of Bells' fiber and advanced services plans on cost accounting and consumers.

87. The deployment of advanced telecommunications throughout the country is a national goal.[113] However, Bells' deployment of advanced services is occurring largely outside regulators' oversight, with Bells, guided solely by strategic interests (and therefore in a public policy vacuum), choosing to deploy advanced services to more densely populated areas and to high-revenue customers. Therefore, it is particularly important that Bells account for expenses and investments devoted to nonregulated services in a fair and rational manner. Specifically, in the allocation of costs between regulated and nonregulated services, costs should follow revenues.

88. In the regulated monopoly model, regulators could ensure that all segments of society benefit from advanced technology.[114] Under today's deregulatory paradigm, where true competition has not yet arrived, but new services are unregulated, consumers

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113 / *See, e.g.*, 47 U.S.C. § 230(b)(1) and 47 U.S.C. §157 nt. (incorporating section 706 of the Telecommunications Act of 1996, Pub. Law No. 104-104, 110 Stat. 56 (1996)); Section 706 of the Act directs the Commission to encourage the deployment of broadband to "all Americans" in a "reasonable and timely basis." *Id. See*, also, the Commission's Broadband Policy Statement. *In the Matters of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities*, CC Docket No. 02-33; *Universal Service Obligations of Broadband Providers, Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, CC Docket No. 01-337; *Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review –Review of Computer III and ONA Safeguards and Requirement*, CC Docket Nos. 95-20, 98-10; *Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities*, GN Docket No. 00-185; *Internet Over Cable Declaratory Ruling*; *Appropriate Regulatory Treatment for Broadband Access To the Internet Over Cable Facilities*; CS Docket No. 02-52, *Policy Statement*, FCC 05-151, Rel. September 23, 2005 ("Broadband Policy Statement").

114 / *See, e.g.*, D.P.U. 89-300, where state regulators directed New England Telephone and Telegraph Company ("NET") (now Verizon) to accelerate its replacement of outdated electromechanical central office switches in rural Massachusetts so that some communities would not be left behind, lacking access to touch tone, while NET advertised then-new features, such as call waiting, in urban and suburban communities. Massachusetts D.P.U. 89-300, *New England Telephone Company*, June 29, 1990. In a separate order, the Massachusetts Department of Public Utilities (now the Department of Telecommunications and Energy) found that ISDN is a "monopoly, basic service that has a potentially far-reaching and significant role in the telecommunications infrastructure of the Commonwealth" and directed NET to deploy ISDN more broadly so that consumers could avail themselves of this then "advanced" technology. ISDN Basic Service, Mass. D.P.U. 91-63-B, February 7, 1992, p. 34.

are vulnerable to two distinct harms as Bells roll out new technology: (1) some consumers will be left behind as the telco-cable duopoly races to attract and to lock in high-revenue customers; and (2) precisely those consumers who are left behind will be forced to subsidize new services.

89. Telephone rates are unreasonably and unjustly high where (1) ILECs have failed to assign and allocate adequate investment and expenses to unregulated services and (2) ILECs have been granted regulatory relief on the false finding of competition adequate to discipline the ILECs. In the former instance, ILECs are over-recovering costs. In the latter instance, ILECs can extract monopoly rent from services that have been prematurely deregulated because the services are no longer subject to regulatory review and competition does not yet exist to constrain the ILECs' market power.

V. THE NEED FOR COMPREHENSIVE DATA

Background

90. The asymmetry of information that presently prevails (where the regulated entities possess far more detailed information about their costs and business plans than do the regulators) hampers regulators' ability to improve cost accounting rules and procedures. The Bells possess detailed information about their costs and revenues, which they provide only in part to regulators.

91. My analysis in this affidavit necessarily relies on public data available from the Commission and reported by the Bells in their reports to investors. However, consumer advocates should be afforded access to the information that Bells submit in response to any data request that the Commission issues in this proceeding so that consumer advocates can refine their analysis and recommendations, as necessary.

92. I have at least three areas of concerns for consumers:

- Is there a mismatch (or potential for a mismatch) between the costs and revenues for regulated and for nonregulated operations?
- As Bells embark on fiber-based data, video, and other new services,[115] will they continue to invest adequately in the telephone plant that is necessary to provide basic service at reasonable levels of service quality?[116]
- Do the Commission's existing cost accounting rules yield information that is sufficient to enable regulators to address the two previous questions?

[115] / In Verizon Communications' second quarter 2006 Investor Quarterly, Ivan Seidenberg, Verizon's chairman and CEO is quoted as stating: "Verizon Telecom is tightly controlling costs in traditional businesses as we make the fiber network investments to accelerate growth and market expansion." Verizon Communications, *Investor Quarterly: VZ Second Quarter 2006,* August 1, 2006, at 2.

[116] / Bells' service quality and the need for economic incentives for them to improve and maintain service quality are under investigation in various state proceedings. *See, e.g.*, New Hampshire Public Utilities Commission Docket No. DT 06-072 and Maine Public Utilities Commission Docket No. 2005-155.

The Commission's Data Request

93. The Commission seeks comments on a draft data request, which it includes as Appendix C to the *FNPRM*.[117] Specifically, the Commission seeks comment on the request's "utility in assisting separations reform efforts, and on whether, as currently drafted, it will help the Commission to elicit useful information towards that end."[118] The Commission also seeks comments on any alternative ways to obtain the desired information.[119]

94. Two critical areas for further analysis are the implications of the increasing demand for DSL and bundled offerings for cost assignment and allocation rules. The FCC's Draft Data Request implicitly acknowledges the importance of (among other things) obtaining better data regarding the treatment of revenues and costs associated with the provision of DSL (part G of the Draft Data Request) and bundled packages (part J of the Draft Data Request). Consumer advocates have raised concerns about the anticompetitive implications of Bells' packaged offerings in numerous proceedings.

95. As the *Glide Path II Paper* states:

> Many telecommunications carriers today offer a variety of competitive and semi-competitive services. Separations applies only to costs that are not excluded under Part 64 of FCC rules, but those rules have not been revised since before Congress mandated local exchange competition. This may suggest that new rules are needed to exclude from separations some new classes of competitive facilities, expenses, and revenues.[120]

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[117] / *FNPRM*, at paras. 31-32, Appendix C. Although the Commission, previously sought comment on a proposed data request in March 2005, it did not attach the actual proposed data request at that time. *FNPRM*, at note 75, citing *Separations Data Request FR Notice*, 70 Fed. Reg. at 11972.

[118] / *Id.*, at para. 31

[119] / *Id.*

[120] / *Glide Path II Paper*, at 6.

96. The Commission should seek detailed information about the Bells' accounting treatment of their investment and expenses associated with the deployment of new services. Two major policy implications result from the Bells' deployment of fiber for new services. First, the costs of such deployment should be recovered from customers subscribing to the new services, and not the entire base of monopoly customers. Second, if, at some point, the Bells fail to derive a reasonable return on their fiber/video/data investments, they should not then be allowed to be "made whole" by recovering costs from regulated service customers.

97. The Commission's draft data request underscores the need for more detailed and comprehensive information. Among other things, it appropriately seeks information about how companies record, for accounting purposes, cost and revenue data for unbundled network elements, wholesale services, interconnection, shared DSL; solo DSL, special access, VoIP, and bundled packages.

98. The Commission should issue the data request expeditiously and make the responses available so that more informed comments about modifications to jurisdictional separations rules can be made. The State Members of the Joint Board proposed that the Commission issue a data request over two years ago (May, 2004).[121] At the time, State Members expressed concerns about the time needed to examine complex separations issues and the paucity of data. The State Members also proposed that the Commisison consider the Joint Conference on Accounting's Recommendation filed October 9, 2003 in

[121] / *FNPRM*, at para. 12, citing Letter from Paul Kjellander, State Chair of Federal-State Joint Board on Separations and President, Idaho Public Utilities Commission, Diane Munns, Chair, Iowa Utilities Board, Judith Ripley, Commissioner, Indiana Utility Regulatory Commission, and John Burke, Board Member, Vermont Public Services Board, to Michael Powell, Chairman, Michael Copps, Commissioner, and Kevin Martin, Commissioner, FCC, dated May 27, 2004 ("State Members May 2004 Letter").

Docket No. 02-269 regarding the addition of accounts and subaccount to the Commission's Part 32 rules.[122] Although the Commission previously sought comment on a proposed data request in March 2005, it did not attach the actual proposed data request at that time, and, instead, focused on the estimated burdens of responding to such a request.[123]

99. As I discuss in more detail in this affidavit below, the Bells have had enormous success in terms of market penetration with their new bundled service offerings and data and video offerings. The Commission has an obligation to review the implications of this large and growing part of carriers' business for the jurisdictional separations rules and to ensure that consumers are not paying inappropriately for services to which they do not subscribe. The current cost accounting rules fail to provide adequate tools to enable federal and state regulators to ensure that the Bells are appropriately assigning costs and revenues for these services. Indeed, in many state proceedings the Bells assert that regulators and intervenors have no need for information regarding the accounting practices related to interstate services. By ensuring that neither state nor federal regulators have the complete picture, the Bells have successfully kept all regulators in the dark.

100. Based on my preliminary analysis of the draft data request, I recommend the following additions to the data request:

For Part G. Digital Subscriber Line:

- Are the costs associated with loops used to provision shared DSL recorded in an account or subaccount created for that purpose?

[122] / State Members May 2004 Letter, at 2.

[123] / *FNPRM,* at note 75, citing *Separations Data Request FR Notice*, 70 Fed. Reg. at 11972.

- In what USOA account(s) are the costs associated with loops used to provision shared DSL recorded?
- Are the accounts or subaccounts in which the costs associated with loops used to provision shared DSL used for other purposes? Please explain.
- Does your company(s) ever assign a shared DSL line's cost to a different jurisdiction than that to which the revenues are assigned? If so, please explain.
- Does your company(s) ever assign a solo DSL line's cost to a different jurisdiction than that to which the revenues are assigned? If so, please explain.

For Part J. Bundled Packages:

- For your largest bundled package (*i.e.* the package that includes the greatest number of services offered), please list the revenue allocation for that service . . . (See J.2.a)
- When your company sells services as part of a bundle, how do you record the costs? For example, how are costs allocated among jurisdictions? How are costs allocated across discrete services in the bundle? For example, how are marketing costs allocated?

101. The Commission should release the current draft data request as soon as possible. The Commission review of comments in response to this *FNPRM* and of data submitted in response to a quickly released data request can then form the basis for another data request if needed. The value to federal and state regulators of obtaining comprehensive data to ensure that rates are fair and economically efficient far outweighs any burden that such a data request would impose. Federal-state coordination and review of a common data set is essential to prevent over-recovery of costs and anti-competitive cross-subsidization of unregulated services with regulated services.

VI. EVOLVING CONSUMER DEMAND UNDERSCORES THE NEED TO CORRECT OUTDATED COST ACCOUNTING RULES

Background

102. The *Glide Path II Paper* states that the Commission "committed itself to work with the Joint Board on four issues," including DSL, private lines, Internet traffic, and unbundled network elements.[124] The *FNPRM* similarly states that the Commission agrees that "as part of their efforts to comprehensively reform jurisdictional separations, the Joint Board and the Commission should address the separations treatment" of these four areas and the "interrelationships between these issues with comprehensive reform."[125] This section of my affidavit discusses these four areas of concern. I analyze the unfair under-allocation of costs to DSL as a way to illustrate my broader concern with the allocation of Bells' costs generally to unregulated services (such as video service, IPTV, and fiber-based services).

Overview of changing consumer demand and jurisdictional shifts in regulation.

103. Numerous factors create a gross mismatch between carriers' accounting of their revenues and costs including: the Bells' pursuit of unregulated lines of business; the Bells' increasing sales of long distance and bundled services which mingle intrastate, interstate, regulated, and unregulated products; the Commission's declaration that wireline broadband services are information services; the deployment of packet switches; and the jurisdictional shift of services such as VoIP and ISP-bound traffic from intrastate

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124 / *Glide Path II Paper,* at 4, citing *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, CC Docket No. 80-286, *Report and Order,* FCC 01-162 (rel. May 22, 2001) ("Freeze Order"), para. 33.

125 / *FNPRM,* at para. 17.

to interstate regulation. For the purpose of illustrating the gross unfairness of Bells' present method of assigning and allocating its telephone plant, this portion of my affidavit focuses on the implications of Bells' use of the common loop as a platform for offering DSL throughout the country. The concerns that I raise with respect to DSL apply generally to the Bells' unregulated services.

Shareholders reap profitable DSL revenues while consumers bear DSL costs.

104. Consumer advocates have raised concerns in other pleadings before the Commission regarding the unfair mismatch between DSL revenues and DSL costs. In one pleading, the following was observed:

> Although BellSouth expresses dismay about its inability to innovate as rapidly as its competitors, Figure 1 shows BellSouth's undeniable success in delivering broadband services to its customers. As bothersome as cost studies may be, they are a small price to pay considering the significant market power that BellSouth enjoys. Figure 1, attached, shows the rapid rate at which BellSouth is penetrating the broadband market with its DSL service, despite cost accounting requirements. The Commission's decision to regulate DSL as an interstate service underscores the need to adjust the now- frozen separations factor. BellSouth presently enjoys the best of both worlds – its DSL revenues are considered interstate and unregulated and yet the vast majority of the costs of the common network that enables BellSouth to offer this service are recovered through intrastate rates.[126]

[126] / *Petition of BellSouth Telecommunications, Inc. for Forbearance Under 47 U.S.C.§ 160 from Enforcement of Certain of the Commission's Cost Assignment Rules,* WC Docket No. 05-342, Initial Comments of the New Jersey Division of the Ratepayer Advocate, January 23, 2006, at 12, cites omitted. *See*, also, the Reply Comments of the New Jersey Division of the Ratepayer Advocate, February 10, 2006, at pages 2 to 3: "However, neither AT&T nor BellSouth address the fact that the unfair and uneconomic separations freeze is a more significant cause of cost increases in local exchange service than compliance with cost assignment rules. The jurisdictional separations factor requires modification in order to align ILECs' cost recovery more closely with cost causation, in light of ILECs' increasing use of the public network for interstate and unregulated services. Furthermore, as is thoroughly explained by Time Warner, BellSouth has failed to demonstrate that the Commission should abandon it prior determinations, which have included "a rigorous and detailed review of its cost accounting rules to determine whether they are still necessary once incumbent LECs are subject to price cap rate regulation and in light of increased competition and changes in technology."

105. These concerns continue to be relevant as the Bells continue to market their DSL services and to offer them over a common platform. Demand for DSL has increased from less than a half-million in 1999 to almost 20 million in 2005.[127]

106. Furthermore, these demand figures come from a Bell network which does not yet offer DSL ubiquitously. DSL availability varies widely among communities, with consumers in urban areas far more likely to have the option to subscribe to Bell-offered DSL than are consumers in rural areas. Nationally, as of 2005, 78 percent of local lines could subscribe to DSL.[128]

107. Although data about aggregate demand are publicly available, public data at a community level about the percentages of households that have the option to subscribe to DSL are unavailable.[129] Similarly, public data are unavailable regarding the penetration of DSL among those *to whom DSL is available.* Therefore, using public data, one can only approximate the percentage of total households that subscribe to DSL, and not the percentage of DSL-capable households that choose to subscribe. Despite these data limitations, however, it is clear that: (1) DSL demand is large and is increasing; (2) Bells' ability to offer DSL depends critically on the Bells' prior deployment of a common

127 / National ADSL demand in 1999 was 369,792; and national ADSL demand in 2005 was 19,514,318. "High-Speed Services for Internet Access: Status as of December 31, 2005," Industry Analysis and Technology Division, Wireline Competition Bureau, July 2006, Table 11. *See also* Appendix E.

128 / *Id.*, Table 14. In comments submitted earlier this year to the Commission, Maine and Vermont regulators and advocates contrasted rural carriers' DSL deployment with that of Verizon: "Rural telephone companies in Vermont and Maine have amply demonstrated the effects of this difference. These rural companies have significantly more DSL deployment than Verizon, the two states' only non-rural carrier." FCC Docket Nos. 96-45, 05-337, Comments of Vermont Public Service Board, Vermont Department of Public Service, and Maine Public Utilities Commission, March 27, 2006, at 14.

129 / In other words, not all customers have the option to subscribe to DSL, and, in particular, consumers in less densely populated areas are less likely to be able to avail themselves of BOC-supplied DSL. Analyses of state-level DSL data (which are typically designated as proprietary by Bells) show the disparate deployment of DSL among communities.

ubiquitous network; and (3) Bells' DSL deployment paves the way for their fiber and video marketing plans.

Consumer advocates have raised concerns about the impact of Bells' unregulated services and interstate services on intrastate rates for many years.

108. Three years ago, in a state proceeding in which the public service commission was investigating a local carrier's revenue requirement, I raised concerns about the carrier's use of common plant in support of its DSL deployment. I recommended that the state regulators allocate a portion of common plant to digital subscriber lines as an integral component of the calculation of the carrier's revenue requirement. The reasoning that I provided then continues to apply to today's environment:

> Because CenturyTel has not yet deployed the full array of advanced services that its network modernization will support nor has it yet realized the potential demand for recently deployed advanced services, there are no specific percentages of existing use that correspond with the 15 percent allocation that I propose. Examining the DSL growth trend offers some relevant information but is by no means a comprehensive measure of consumers' demand for interstate and unregulated services, nor of the Company's strategic reasons for network modernization. As of June 2003, approximately 2.3 percent of CenturyTel's lines subscribed to DSL. Assuming the same absolute growth as occurred between June 2002 and June 2003 (i.e., 1132 DSL lines per year), DSL lines will comprise approximately 5.7 percent of CenturyTel's lines in June 2007 and approximately 9 percent of CenturyTel's access lines in 2011.

I explained further:

> Furthermore, consumers' demand for services is an incomplete basis of cost allocation because a Company may decide to modernize plant to offer a new unregulated service for which demand never materializes, or for which the Company's projected demand exceeds the actual demand. Consumers of intrastate regulated services should not be expected to bear the cost of implementing business plans for unregulated or interstate services that may not yield the anticipated returns. CenturyTel's ambitious network upgrading clearly benefits its pursuit of unregulated and/or interstate services that neither its allocation methodology nor the separations process reflects. CenturyTel proclaims to its stockholders that its "aggressive deployment of DSL is the direct result of a multi-year network evolution plan" and further states that its "high-quality

> infrastructure includes 100 percent digitally switched telephone networks, more than 15,000 route miles of fiber optics in the local telephone network and a supporting ATM backbone network." CenturyTel further explains that "[t]his network evolution plan of shortening loop lengths and bringing fiber closer to the home allows CenturyTel to provide high-speed data services to the customer and positions us to generate additional revenues from a variety of broadband services in the years ahead."

Based on my analysis of CenturyTel's plant investment, I concluded:

> It is unfair and economically inefficient for consumers of intrastate regulated services to bear a disproportionate share of the Company's fiber deployment and deployment of other technology, which are motivated in large part by the Company's business interest in pursuing new revenue streams from "a variety of broadband services." Viewed this way, 15 percent likely underestimates a fair and efficient allocation of common plant.[130]

109. Consistent with my recommendation to the Arkansas Public Service Commission in 2003, I continue to recommend that state regulators allocate a fair share of common plant to unregulated services that rely on the existence of the common platform.[131] The

[130] / *In the Matter of the Application of CenturyTel of Northwest Arkansas, LLC for Approval of a General Change in Rates and Tariffs,* Arkansas Public Service Commission Docket No. 03-041-U, Testimony of Susan M. Baldwin on behalf of the Attorney General, filed October 9, 2003, at 18-19, cites omitted. The case ultimately was resolved through the Arkansas Public Service Commission's approval of a stipulation. *In the Matter of the Application of Approval of a General Change in Rates and Tariffs, CentutyTel of Northwest,* Arkansas Public Service Commission, Docket No. 03-041-U, *Order No. 8*, January 29, 2004. CenturyTel originally sought a general rate increase of $36 million. Pursuant to the Stipulation that the Arkansas Public Commission approved, CenturyTel increased rates by only $3 million.

[131] / Other consumer advocates have made similar proposals. The Vermont Public Service Board adopted the recommendation of the Vermont Department of Public Service to require Verizon to remove $3.212 million in investments and $720,718 in annual expenses associated with special access services (primarily relating to Frame Relay and Asynchronous Transfer Mode services) from the company's intrastate cost of service. In reaching its decision, the Department found that Verizon had failed to heed FCC's instructions to update annually investments, expenses, and revenues that prior to the Freeze Order had been subject to direct assignment. Instead, Verizon assigned 70% of the costs relating to special access services to the intrastate jurisdiction, while it assigned the majority of the associated revenues to the interstate jurisdiction. *Investigation into a Successor Incentive Regulation Plan for Verizon New England Inc., d/b/a Verizon Vermont,* State of Vermont Public Service Board Docket No. 6959, Order, Order entered 9/26/2005, at Section 53. In summarizing the impact on competition of misallocating costs between jurisdictions, Department of Public Service witness David Brevitz noted that the "net effect is that Vermont's intrastate services are subsidizing Verizon's wireless, DSL, and Global Networks offerings." Brevitz Direct Testimony, November 9, 2004, at 103. *See, also,* Maine Public Utilities Commission Docket No. 2005-155, Investigation into Verizon Maine's Alternative Form of Regulation, Direct Testimony of Robert Loube, September 26, 2005.

Commission's revisions to its cost accounting rules would assist state regulators in ensuring that unregulated services bear a fair share of common costs, but states should not postpone their analyses of carriers' costs until the Commission issues such revisions. Later in my affidavit, I estimate the magnitude of local loop plant, nationally, that should be allocated to unregulated services *before* the Commission applies the separations process.

The flaws in the cost accounting system harm consumers of intrastate regulated service.

110. The Bells' ability to offer DSL is directly linked to common plant that also supports POTS and other intrastate regulated services. Revenues from intrastate regulated services have enabled the Bells, over the years, to build and maintain the common network, which the Bells are now able to use to derive new revenue streams. Since the revenue is not regulated, a fair and efficient share of costs should be assigned/allocated to DSL.[132] The absence of such a mechanism in the existing cost accounting framework is an egregious and fundamental flaw that merits prompt remedy. Furthermore, the *Glide Path II Paper*, and the Commission's *FNPRM* unambiguously

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[132] / I recognize that there is a distinctly different policy issue related to DSL, *i.e.*, the deployment of broadband to rural, unserved, and underserved areas. The FCC's modification to its existing cost accounting rules to correct for the present imbalance between the allocation of DSL revenue and costs merits prompt attention. An unintended consequence of such a correction might be to create a dis-incentive for deployment in rural areas (*i.e*., since, under the modified accounting, the Bell could no longer recover 75 percent of common costs from the POTS customer base (through intrastate basic exchange rates and the interstate subscriber line charge), Bells would have yet one more reason to delay DSL deployment in areas that might not be profitable. This secondary effect, however, pales in significance to larger causes for disparate broadband deployment, namely the Commission's August 2005 decision ultimately to exempt DSL from USF contributions. Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, Universal Service Obligations of Broadband Providers, CC Docket No. 02-33, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853 (2005). As recently stated by Commissioner Copps, "DSL and cable broadband – which are surely going to be the backbone of our nation's telecom infrastructure for years to come – can build where they choose and profit as they can without contributing towards making these services available to harder-to-reach people." *USF Contribution Order*, Statement of Commissioner Michael J. Copps Approving in Part, Concurring in Part, at 2. Incumbent carriers' uneven DSL deployment merits scrutiny by federal and state regulators.

recognize that cost accounting for DSL is one of four issues that merits particular attention.

Remedies to correct the cost accounting flaws.

111. The primary account where the Bells burden intrastate regulated services customers, while failing to assign and allocate adequate costs to DSL services is the Cable and Wire Facilities Account, which supports the local loop. The relevant investment includes those facilities in "Category 1" which includes those facilities between local central offices and subscriber premises.[133] Row 1530 of the ARMIS Report 43-04 includes the total Cable & Wire Facilities investment.[134] Within this category, the relevant subcategory is Category 1 (Row 1460) which corresponds with all exchange line investment. The following analyses of Bells' investment focus specifically on Row 1455, which corresponds with that portion of Category 1 investment designated as "Joint Use" and which represents the vast majority of exchange line Cable & Wire Facilities investment.[135] For the purpose of illustrating the gross misallocation of this account, this section intentionally oversimplifies the assignment and allocation of costs.[136] Subcategory 1.3 corresponds with the "[s]ubscriber or common lines that are jointly used for local exchange service and exchange access for state and interstate

[133] / 47 CFR § 36.152(a)(1).

[134] / ARMIS Access Report, 43-04, Table 1, Separations and Access Data, This amount corresponds roughly to the amount provided in ARMIS Joint Cost Report 43-03, Table 1, Regulated/Non-regulated, Row/Account 2410 (cable and wire facilities), column m ("subject to separations"). ARMIS Report 43-03 includes data for regulated and nonregulated operations. ARMIS Report 43-04 includes data for regulated accounts subject to separations.

[135] / Cable & Wire Facilities, in turn, represent a significant portion of Total Telephone Plant Investment – All Categories (Row 1540).

[136] / For example, as I explain below, I rely on ARMIS Report 43-04, which provides "post Part 64" data because the "pre Part 64" ARMIS Report 43-03 does not provide relevant cost data for the local loop.

exchange services."[137] The following analysis is not intended to replicate detailed accounting accuracy, but rather is intended to illustrate, at a broad level, the flaws in the current system.

112. The present system is grossly unfair because DSL gets a "free ride" on the common plant. For example, Table 5, below, which is based on ARMIS Report 43-04, shows that the Bells' local loop investment of more than one hundred billion dollars supports an increasing percentage of digital subscriber lines. Under the present, flawed system, Bells assign and allocate the vast majority of cable and wire investment to their regulated operations.

[137] / 47 CFR § 36.154(a).

Table 5

DSL "Free Rides" on Local Loop Investment

Year 2000	**Local Loop Investment**	**Switched Access Lines**	**DSL Connections**	**DSL Ratio***
AT&T	$38,002,020,000	58,041,420	767,000	1%
BellSouth	$21,795,268,000	25,087,026	215,000	1%
Qwest	$13,478,829,000	17,626,160	271,000	2%
Verizon	$44,274,219,000	63,016,104	540,000	1%
Bell Total	$117,550,336,000	163,770,710	1,793,000	1%
Year 2005				
AT&T	$45,197,899,000	44,062,251	6,921,000	14%
BellSouth	$25,462,175,000	18,808,132	2,882,000	13%
Qwest	$16,226,143,000	12,800,540	1,480,000	10%
Verizon	$49,215,330,000	48,636,292	5,144,000	10%
Bell Total	$136,101,547,000	124,307,215	16,427,000	12%
Bell Total % Change, 2000-2005	16%	-24%	816%	

* DSL Ratio is the ratio of DSL connections to the sum of DSL connections and switched access lines.

Sources: Local Loop Investment: ARMIS Report 43-04, Table I. "Separations and Access Data," Row 1455 (C&WF Cat. 1 - Exch. Line - Joint Use). Switched Access Lines: ARMIS Report 43-08, Table III. "Access Lines in Service by Customer," Row 910. DSL Connections: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; Qwest 2002 Annual Report, page 37; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13.

113. To illustrate the magnitude of the investment that should be allocated to Bells' DSL operations, the following analyses provide general estimates of the effect of correcting the presently flawed cost accounting system. The starting points for all three methodologies are the investment amounts shown for common loop plan (*i.e.*, Row 1455 of ARMIS Report 43-04).[138]

[138] / Although Report 43-03 shows the regulated/non-regulated split, it does not disaggregate to show the portion of cable and wire facilities that correspond with Category 1 – the local loop.

114. I apply three methodologies to correct the inadequate assignment and allocation of local loop plant to unregulated services,[139] which rely on DSL demand, DSL revenues, and cost causation. The revised allocation of plant would also lead to a corresponding revision to the apportionment of expenses, such as maintenance expenses, customer operations expenses, and other expenses. All three methods *understate* the total investment that should be allocated to unregulated services, because they do not address Bells' increasing deployment of video services. Furthermore, all three methods are assumed to be applied *pre-separations*.

115. Method 1, shown in Table 6, relies on the 2005 ratio of DSL lines to the sum of total switched access lines and DSL lines to re-apportion plant This method, which assigns and allocates approximately $16 billion to DSL, understates the cost that should be allocated to unregulated services because (1) as Table 3 and Figure 2, above, show, DSL demand continues to grow; and (2) as the Bells increase their DSL deployment, suppressed demand (customers that would subscribe if they had the ability to do so) will materialize. Also, Method 1 understates the fair share of costs that DSL should bear because Bells' ability to market DSL depends on the ubiquitous availability of POTs.

[139] / The starting point values exclude a minor portion already allocated away to nonregulated in Report 43-03. Within the larger context, this has minimal effect on the illustration of the magnitude of dollars at stake.

Table 6

Correcting Outdated Cost Accounting Rules

Method 1: Demand-Based Correction - Loops

	Local Loop Investment	DSL ratio	2005 Demand-Based Correction
AT&T	$45,197,899,000	14%	$6,135,635,779
BellSouth	$25,462,175,000	13%	$3,383,196,946
Qwest	$16,226,143,000	10%	$1,681,637,504
Verizon	$49,215,330,000	10%	$4,707,368,594
Bell Total	$136,101,547,000		$15,907,838,823

Note: The 2005 Demand-Based Correction - Loops method matches investment with demand for DSL connections. For example, because DSL connections account for 14% of AT&T's total of switched access lines and DSL connections, 14% of the local loop investment is allocated to nonregulated services.

Sources: Local Loop Investment: ARMIS Report 43-04, Table I. "Separations and Access Data," Row 1455 (C&WF Cat. 1 - Exch. Line - Joint Use). Switched Access Lines: ARMIS Report 43-08, Table III. "Access Lines in Service by Customer," Row 910. DSL Connections: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; Qwest 2002 Annual Report, page 37; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13.

116. Utilizing Method 2, shown in Table 7, I estimate that DSL should bear between $5 billion and $15 billion of the Bells' local loop investment. Method 2 relies on the Bells' reported regulated revenues,[140] and a "low" and a "high" estimate of Bells' DSL revenues. My estimates of the Bells' DSL revenues appear in Table 2 above, and are based on demand data that the Bells report in their annual reports and investor quarterlies,

[140] / ARMIS Report 43-01, Table I, Regulated/Nonregulated Revenues and Costs Report (in Current Corporate Structure).

and pricing information that the Bells provide on their web sites. Because these revenue estimates do not include other components of the bundle (such as long distance service), the estimates are biased downward.

Table 7

Correcting Outdated Cost Accounting Rules

Method 2: Demand-Based Correction - 2005 DSL Revenues

	Local Loop Investment	Regulated Revenues	DSL Revenues		Allocation Percentages		Allocation Amounts	
			Low Estimate	High Estimate	Low Estimate	High Estimate	Low Estimate	High Estimate
AT&T	$45,197,899,000	$34,261,646,000	$1,078,845,480	$4,567,029,480	3%	12%	$1,379,764,316	$5,316,177,660
BellSouth	$25,462,175,000	$16,738,230,000	$862,870,800	$3,802,510,800	5%	19%	$1,248,249,616	$4,713,568,823
Qwest	$16,226,143,000	$9,925,754,000	$479,342,400	$1,106,980,800	5%	10%	$747,506,609	$1,628,066,756
Verizon	$49,215,330,000	$35,651,621,000	$925,302,720	$2,466,033,600	3%	6%	$1,245,022,109	$3,184,001,185
Bell Total	$136,101,547,000	$96,577,251,000	$3,346,361,400	$11,942,554,680	3%	11%	$4,620,542,650	$14,977,912,621

Note: The Demand-Based Correction - DSL Revenues method allocates local loop investment to nonregulated services based on a comparison of revenues derived from DSL services and overall regulated revenues. For example, because the estimates of AT&T's DSL revenues are between 3% and 12% of AT&T's overall regulated revenues, 3% to 12% of AT&T's local loop investment should be allocated to nonregulated services.

Sources: Local Loop Investment: ARMIS Report 43-04, Table I. "Separations and Access Data," Row 1455 (C&WF Cat. 1 - Exch. Line - Joint Use). Switched Access Lines: ARMIS Report 43-08, Table III. "Access Lines in Service by Customer," Row 910. DSL Connections: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; Qwest 2002 Annual Report, page 37; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13; Websites for AT&T, BellSouth, Qwest, and Verizon, visited 8/1/2006.

117. Method 3, shown in Table 8 assumes that local loop investment is split evenly between switched access lines and DSL, and, therefore assigns and allocates $68 billion of local loop plant to unregulated services. Bells require the local infrastructure in order to offer DSL in competition with cable companies. For many years, Bells incorporated excess capacity in their local loop to accommodate additional lines.[141] Similarly, Bells

[141] / In numerous TELRIC proceedings, Bells contended that low fill factors for local loop distribution plant should be used in calculating UNE costs to accommodate spare capacity. *See, e.g., Illinois Bell Telephone Company, Filing to increase Unbundled Loop and Nonrecurring Rates (Tariffs filed December 24, 2002)*, Illinois Commerce Commission Docket No. 02-0864, Direct Testimony of Randall S. White (SBC), at 9; *In the Matter of the Application of Southwestern Bell Telephone, L.P., d/b/a SBC Arkansas to set rates for unbundled network elements*, Arkansas Public Service Commission Docket No. 04-109-U Direct Testimony of John C. Trott (SBC) at 17. In Massachusetts, Verizon proposed a distribution fill factor of 40.5%, and the Massachusetts DTE ordered a distribution fill factor of 48%. Massachusetts D.T.E. 01-20, *Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Pricing, based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided-Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts*, July 11, 2002, at 174 and 185.

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depend on the existence of all switched access lines in order to be offer DSL to any particular customer. For this reason, DSL should bear half the cost of the local loop.

Table 8[142]

Correcting Outdated Cost Accounting Rules

Method 3: Cost Causation

	Local Loop Investment	50% Cost Causation Correction
AT&T	$45,197,899,000	$22,598,949,500
BellSouth	$25,462,175,000	$12,731,087,500
Qwest	$16,226,143,000	$8,113,071,500
Verizon	$49,215,330,000	$24,607,665,000
Bell Total	$136,101,547,000	$68,050,773,500

Note: The Cost Causation method assumes that one half of the local loop investment should be allocated to nonregulated services.

118. The Commission should not await the end of the freeze, which is potentially in 2009,[143] but rather should implement corrective action within the year, and should, consistent with my analysis and recommendations in this affidavit, encourage states to fulfill their responsibility to ensure that DSL bear a fair share of the cost of common loop. Table 9 summarizes my illustrative estimates of the magnitude of the local loop investment that should be assigned and allocated to unregulated services.[144]

[142] / *See*, Table 5 for underlying data and sources.

[143] / The Commission extended the separations freeze on an interim basis for "no longer than three years from the initial date of this extension or until such comprehensive reform can be completed, whichever is sooner." *FNPRM*, para. 16.

[144] / *See*, Tables 6, 7, and 8.

Table 9

Billions Of Dollars In Common Plant Should Be Allocated To Unregulated Services:

Illustrative Estimate Of Alternative Cost Assignment/Allocation Methodologies

	Billions of Dollars
Method 1: Demand-Based Correction - Loops	$16
Method 2: Demand-Based Correction - 2005 DSL Revenues	$5 - $15
Method 3: Cost Causation Correction	$68

Note: This table uses DSL to illustrate the magnitude of common plant that should be allocated away from basic local exchange services. This table does not address other unregulated services.

119. Bells derive substantial marketing strategy advantages from their ability to offer DSL and are able to leverage DSL as part of a larger market segmentation effort. By selling DSL and associated bundles (see Section VII), they lock in customers. Then, as the Bells roll out fiber to the node or to the home, those customers willing to pay for the advanced service roll over from DSL-based packages to fiber-based packages.[145] Those customers satisfied with DSL remain with Verizon. If, by contrast, Bells had to start "from scratch" with their video sales, they would incur substantially greater marketing and customer acquisition costs.

120. Any algorithm for cost allocation is necessarily imperfect. Nonetheless, the present cost allocation situation is severely imbalanced, favoring the Bells shareholders

[145] / "Verizon Expands FiOS TV Availability in Massachusetts: Consumers in Burlington, North Reading and Winchester Can Experience Better Television; New Service Provides More Choice and Greater Value," June 29, 2006, http://newscenter.verizon.com/proactive/newsroom/release.vtml?i d=93560, site visited July 10, 2006. This press release is reproduced in Appendix D.

over their basic consumers because the shareholders reap the profits and consumers bear the costs. The Commission and state regulators should place the burden on the Bells to identify appropriate mechanisms, and in the absence of any reasonable and workable Bell proposals, should adopt and to implement a variation of one of the approaches discussed above.

Interstate special access demand growth vastly outpaces intrastate special access demand growth, which provides compelling evidence of the need for regulators to assign private line costs directly to the proper jurisdiction.

121. As recognized in the *FNPRM* and the *Glide Path II Paper*, "[d]uring the freeze, telecommunications providers have sold increasing numbers of "special access" circuits," which, under existing rules, if the traffic is "contaminated" (that is, carries ten percent or more interstate usage), the circuits are classified as interstate services.[146] The Commission seeks input with respect to the ramifications of private line and special access growth for separations.[147]

122. The existing Commission rules state that "[d]irect assignment of private line service costs between jurisdictions shall be updated annually. Other direct assignment of investment, expenses, revenues or taxes between jurisdictions shall be updated annually."[148] As discussed in Section VI of my affidavit, however, carriers are balking at complying with this requirement.

123. The growth of special access lines demonstrates the magnitude of this factor on carriers' separation of costs between the interstate and intrastate jurisdictions. If carriers

[146] / *Glide Path II Paper*, at 5.

[147] / *FNPRM*, at para. 33.

[148] / 47 C.F.R. § 36.3(a).

complied with the requirement to assign plant, a significantly higher portion of plant would be assigned to the interstate jurisdiction.

124. According to the Commission's *Statistics of Communications Common Carriers*, special access revenues for the Bells increased 29% in just one year from December 31, 2000 to December 31, 2001 and increased a total of 61% between December 31, 2000 and December 31, 2004 (from $9.4-billion to just over $15-billion).[149] The number of special access lines increased by 103% between December 31, 2000 and December 2004.[150] Therefore, the plant associated with this huge growth should be shifted from the intrastate jurisdiction (where it is erroneously "frozen") to the interstate jurisdiction.

125. In the Commission's special access proceeding, the New Jersey Rate Counsel stated: "The RBOCs argue that the use of ARMIS data to estimate rates of return is flawed. For example, Qwest argues that the rate of return statistics cited by the Commission are useless because of the distortions of revenue assignments and cost allocations. The Ratepayer Advocate recognizes that there are legitimate concerns regarding the use of ARMIS data."[151]

126. The increases in Special Access revenues have not gone unnoticed by the Bells. The increase was highlighted by declarants on behalf of AT&T and BellSouth in the

[149] / FCC, *Statistics of Communications Common Carriers*, for years ended December 31, 2001 through December 31, 2004, Table 2.8, year ended December 31, 2000, Table 2.10. Special Access Revenues (Acct No. 5083).

[150] / *Id.*, Table 2.6. Total special access lines include Special Access Lines (non-switched) analog (4kHz or Equiv) and Special Access Lines (non-switched) digital (64 kbps or Equiv).

[151] / *In the Matter of Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25; *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593, Reply Comments of the New Jersey Division of the Ratepayer Advocate, July 29, 2005, citing Comments of Qwest Communications International, Inc., June 13, 2005, at 4, 11.

Commission's review of the proposed merger: "the FCC's Statistics of Common Carriers report that revenue from special access services increased 61% between 2000 and 2004 while revenue from switched access services fell 4 percent."[152] As discussed above, the Bells seek to prevail in two incompatible areas – on one hand attempting to justify their supracompetitive profits from interstate special access services by pointing to misallocation of costs and then, on the other hand, refusing to assign interstate special access investment to the interstate jurisdiction.

127. The line and revenue growth illustrated above provides compelling evidence that the Commission should urge states to ensure that carriers directly assign private lines and special access circuits.

128. Table 10, below, provides further evidence that carriers are deriving an increasing share of revenues from interstate services during this period of frozen separations. Between 1999 and 2004, intrastate revenues declined by approximately three billion dollars (or 5 percent) while interstate revenues increased by approximately seven billion dollars (or 32 percent).[153]

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[152] / *In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, WC Docket No. 06-74, Reply Declaration of Dennis W. Carlton and Hal S. Sider, June 19, 2006 ("Carlton/Sider Reply Declaration"), at para. 30.

[153] / FCC *Universal Service Monitoring Report*, Year 2000 through Year 2005 Editions, Table 11.7.

Table 10

Bells Derive Increasing Share of Revenues From Interstate Services
During Period Of Frozen Separations
Total Operating Revenues - Bell Operating Companies
(in thousands of dollars)

	1999	2000	2001	2002	2003	2004	Change 1999-2004	% Change 1999-2004
Subject to Separations	$85,038,989	100,619,074	$100,441,874	$94,792,982	$91,867,480	$89,077,283	$4,038,294	5%
Intrastate	$62,307,338	72,378,180	$70,475,197	$65,593,177	$62,212,963	$59,141,011	-$3,166,327	-5%
Interstate	$22,731,644	28,240,898	$29,966,689	$29,199,798	$29,654,502	$29,936,275	$7,204,631	32%
Percent Interstate	27%	28%	30%	31%	32%	34%	-	-

Sources: *Universal Service Monitoring Report,* Year 2000 through Year 2005 Editions, Table 11.7.

The Commission should update separations factors to reflect major shifts in switched traffic.

129. The Commission's findings that ISP-bound communication and VoIP service are jurisdictionally interstate occurred without any changes to the separations process. As explained in the *Glide Path II Paper,* "a substantial proportion of apparently local traffic is interstate. Following expiration of the freeze, it is not clear whether traffic measurement would or could address this new environment nor what adjustment to fixed or traffic sensitive factors would be appropriate to reflect the shift of jurisdiction of what formally were intrastate services."[154]

130. The Commission seeks comment on the proposal of the State Members of the Joint Board, submitted in the *IP-Enabled Services* docket,[155] to change usage factors by transferring 33 percent of each company's current local DEM to the interstate jurisdiction, recalculating separations factor consistent with this DEM transfer, and

[154] / *Glide Path II Paper*, at 7.

[155] / *IP-Enabled Services: Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, WC Docket Nos. 04-36 and 03-211, Late-Filed Comments by State Members of the Joint Board, October 26, 2004 ("State Members IP-Enabled Services Comments").

assigning 100 percent of a carrier's investment to the interstate jurisdiction where the carrier has converted its network to the IP format.[156]

131. The Commission's decision to extend the separations freeze perpetuates a severe imbalance between intrastate and interstate costs and revenues for switched traffic. The Commission's decisions to assert jurisdiction over VoIP and ISP-bound traffic and yet also to freeze the factors that are used to separate investment relating to usage unfairly burden intrastate rates with costs that should be shifted to the interstate jurisdiction. As stated by the State Members of the Separations Joint Board: "In summary, preemption would exacerbate the tendency of VoIP traffic to impose costs on the state jurisdiction, but with little or no revenue; and it could prevent states from collecting a reasonable contribution to joint and common costs from VoIP traffic."[157]

132. Because local loop investment represents the largest category of carriers' plant investment, the Commission's initial priority should be to ensure that carriers allocate adequate common plant to its unregulated and its interstate operations. Resolving the implication of the jurisdictional shift in traffic should occur subsequently.

The Commission should clarify the jurisdictional ambiguity about unbundled network elements.

133. Although Bells are no longer required to provide unbundled network elements ("UNE") at rates based on total element long run incremental cost ("TELRIC"),[158] Bells

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[156] / *FNPRM*, at footnote 80, citing *State Members IP-Enabled Services Comments*, at 21-22.

[157] / *In the matter of IP-Enabled Services*, WC Docket No. 04-36, *In the Matter of Vonage Holding Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, WC Docket No. 03-211, Late-Filed Comments by State Members of Separations Joint Board, October 26, 2004, at at 2.

[158] / *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, FCC WC Docket No. 04-313; CC Docket No. 01-338, *Order on Remand*, rel. February 4, 2005 ("Triennial Review Remand Order" or "TRRO"), at para. 227.

continue to offer UNE under commercially "negotiated"[159] arrangements. The way in which Bells account for the costs and revenues of UNEs is unclear.

134. The Commission should clarify the jurisdictional classification of unbundled network element ("UNE") revenues and costs. At a minimum, the Commission should direct carriers to assign revenues and costs to the same jurisdiction and to provide federal and state regulators with detailed evidence of compliance with this directive.

[159] / As the industry becomes increasingly concentrated, CLECs' ability to "negotiate" declines.

VII. IMPLICATIONS OF BELLS' INCREASING RE-MONOPOLIZATION OF TELECOMMUNICATIONS MARKETS

The Bells' phenomenal success in selling bundled services raises significant regulatory concerns and highlights the need to reform the separations rules expeditiously.

135. One of the key regulatory freedoms that the Bell companies obtained in recent years was long distance authority. Section 271 approvals provided the Bells an avenue for re-monopolizing telecommunications markets. Furthermore, legacy SBC's acquisition of legacy AT&T, and Verizon's acquisition of MCI eliminated major rivals to the remaining Bells, further entrenching their control of the long distance market.

136. The Bells' entry into the long distance market has been, and continues to be, enormously successful, which, in turn, creates a need for improved cost accounting tools to detect any anti-competitive cross-subsidization. According to annual and quarterly financial reports:

- In the second quarter of 2006, BellSouth served almost 7.5 million long distance lines, a 46% increase from the second quarter of 2004;[160] 60% of primary residential access lines subscribe to BellSouth long distance; and 46% of primary residential access lines subscribe to BellSouth Answers bundles.[161]

160/ BellSouth Corporation, "Quarter Financial View 1Q04 – Present" available at http://media.corporate-ir.net/media_files/irol/95/95539/2q06_quarterly.xls (accessed August 9, 2006).

161 / BellSouth Corporation, *BLS Investor News*, July 24, 2006, at 8-9.

- AT&T's base of long distance lines grew from approximately 14.4 million at the end of 2003 to 23.5 million at the end of 2005, an increase of 63%[162] and sixty-eight percent of AT&T's retail customers subscribed to a bundle as of year-end 2005.[163]
- Qwest served more than 4.8 million long distance customers at the end of the second quarter 2006 compared to just over 4 million at the end of the second quarter 2004, a 19% increase[164] and bundle penetration reached 54% as of June 30, 2006.[165]
- Verizon reported a 40% increase in mass-market bundle subscriptions between June 30, 2005 and June 30, 2006 and now provides 6.9 million mass market customers with its Freedom packages[166] and the total number of long distance lines served by Verizon increased 15.5% from December 31, 2003 to December 31, 2004 and increased 5.7% from December 31, 2004 to December 31, 2005.[167]

162/ *AT&T 2005 Annual Report*, May 5, 2006, at page 25. I cite end of year 2005 data for AT&T because the latest quarterly results include data for lines losses of legacy AT&T which made a decision to discontinue marketing its mass market services.

163 / AT&T *Investor Briefing*, 4Q 2005, January 26, 2006, page 5.

164 / Qwest Communications, "Historic Quarterly Results – 1Q04 through 2Q06", available at http://phx.corporate-ir.net/phoenix.zhtml?c=119535&p=irol-reportsAnnual (accessed August 9, 2006).

165 / Qwest Communications News Release, "Qwest Reports Higher Sequential Net Income, Continued Margin Expansion, and Strong Free Cash Flow," August 1, 2006.

166 / Verizon Communications, *Investor Quarterly 2Q 2006*, August 1, 2006, at 6.

167 / Verizon Communications, 2005 Annual Report, at 16. As of the end of the first quarter 2005, 58% of Verizon residential customers subscribed to local and long distance and/or DSL service. Verizon Communications *Investor Quarterly 1Q 2005*, April 27, 2005, at 3.

Additional details about the Bells' success in selling bundled services are provided in Appendix E to my affidavit.

137. The Bells have been far more successful in entering new markets than have CLECs. Considering that the Bells received their most recent approvals to offer long distance service less than four years ago (and their first approvals about seven years ago), this success is enormous compared to the minimal inroads that CLECs have made in the local markets that the Bell serve. The 1996 Act was enacted more than a decade ago, and yet CLECs collectively have garnered, at most, a 19% percent market share in the local market.[168] In approximately half the time, the Bells have has made twice the inroads into the long distance market than all the CLECs have made over ten years. In other words, collectively the CLECs have been less than half as successful as the Bells have been, and have taken about twice as long as the Bells to achieve that tenuous success.

138. The Bells' long distance authority makes it vastly harder for CLECs to compete in local markets. The Bells' substantial and unique advantage in the race to offer consumers bundled packages is directly tied to their century-long relationship with consumers, as the primary link to the public switched telephone network. Mass market consumers, through many years of predictable demand for the Bells' essential local telephone services, enabled the Bells' to establish a formidable position in the telecommunications marketplace. The combination of their entrenched position in the local market with their deployment of substantial resources to attract consumers to numerous packages is helping the Bells lock in their market power.

168/ According to Commission-reported data, as of December 31, 2005, CLECs account for 18% of end-user switched access lines, down from 19.1% in June 2005. Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, *Local Telephone Competition: Status as of December 31, 2005*, released July 2006, at Table 1.

139. Furthermore, the most recent wave of mergers (Verizon's acquisition of MCI and SBC's acquisition of AT&T) enabled the Bells to buy out their actual and potential competitors and acquire invaluable access to an embedded base of customers. As the Bells move into new competitive markets, including broadband markets, it is essential to ensure that basic non-competitive services are not cross-subsidizing these new services. It is also essential to ensure that the Bells do not neglect the more "mundane" responsibilities of installing and repairing basic telephone service in a timely manner.[169]

140. Consumer advocates have raised concerns in various Commission proceedings about the anticompetitive implications of Bells' increasing sales of bundled offerings.[170] As I discuss below, improved, uniform cost assignment and allocation rules would assist federal and state regulators in detecting anticompetitive pricing of bundled offerings. Consumers of non-bundled services are at risk of subsidizing Bells' bundled offerings. Also, the inadequate assignment and allocation of costs to bundled offerings jeopardizes CLECs' ability to compete with Bells.

[169] / In Verizon Communications' second quarter 2006 Investor Quarterly, Ivan Seidenberg, Verizon's chairman and CEO is quoted as stating: "Verizon Telecom is tightly controlling costs in traditional businesses as we make the fiber network investments to accelerate growth and market expansion." Verizon Communications, *Investor Quarterly: VZ Second Quarter 2006*, August 1, 2006, at 2.

[170] / *See, e.g., In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, FCC WC Docket No. 06-74, Comments on Behalf of the New Jersey Division of the Ratepayer Advocate, June 5, 2006, at 9-10; *In the Matter of Transfer of Control Filed by SBC Communications Inc. and AT&T Corp*., FCC WC Docket No. 05-65, Comments of the New Jersey Division of the Ratepayer Advocate, April 25, 2005, at 11 and Reply Comments of the New Jersey Division of the Ratepayer Advocate, May 10, 2005, at 6-9; *In the Matter of Verizon Communications Inc. and MCI, Inc., Applications for Approval of Transfer of Control*, WC Docket No. 05-75, Comment of the New Jersey Division of the Ratepayer Advocate, May 9, 2005, at 8-9 and Reply Comments of the New Jersey Division of the Ratepayer Advocate, May 24, 2005, at 6-10.

The Bells' bundled packages lock in customers.

141. The Bells' packages are clearly intended to attract customers who seek the convenience of flat rate calling and a single bill for multiple telecommunications services. For example, AT&T's website includes the following: "A World of Savings. Delivered Online. Get the mix of products and services that work best for you - on one money-saving bill. Build your bundles today!"[171] The Bells' aggressive foray into the bundled services market makes it that much harder for CLECs to make headway in local markets.

142. Indeed, in addition to the business goal of seeking to attract customers in the high revenue segment of the market, the desire to lower customer churn is one of the industry's key motivating reasons for marketing bundled offerings to customers. The Commission stated in its Order last year approving the acquisition of AT&T by SBC:

> SBC's documents reveal that its research and development, marketing, and corporate strategies focus upon service offerings designed to encourage consumers to subscribe to a local and long distance service bundle. SBC's incentive is to drive consumers to purchase all telephone services from SBC to reduce its marketing costs and churn, as well as to increase its average revenue per user.[172]

[171]/ Available at: https://swot.sbc.com/swot/bundleCatalog.do, accessed June 3, 2006.

[172]/ *SBC/AT&T Merger Order*, at note 297, citing SBC/AT&T Reply at 89-91; SBC Investor Briefing, April 21, 2004 at 5; SBC Investor Update, SBC 2004 First Quarter Earnings Conference Call, Apr. 21, 2004 at 6, 16, 18; SBC Info. Req., SBC24705-22. The Commission also stated, "[m]oreover, these strategies are revealed by the marketing of its bundled service offerings, as well as its policy of requiring consumers to subscribe to its local service as a prerequisite to subscribing to its long distance service." *Id.*, citing, SBC Residential Solutions (visited Aug. 19, 2005) available at http://www02.sbc.com/Products_Services/Residential/Catalog/1,,13--1-3-13,00.html; see also, e.g., SBC Info. Req., SBC57075 at 57089; SBC218651 at 218693; SBC121379 at 121381, 121388; SBC39089 at 39098, 39140-41. *See, also, Verizon/MCI Merger Order*, at note 296, citing, Verizon Second Quarter 2005 Earnings Conference Call at 6, wherein it was stated: "In consumer, our approach to the marketplace is to focus on customer retention and loyalty, while increasing the average monthly revenue per customer through these new services and higher penetration of bundles and packages."

143. The Bells have provided statistics to investors demonstrating that bundling products together improves customer retention as well as revenues per line:

> AT&T told investors: "We have found that when customers add broadband to a basic package, they are 40 percent less likely to switch to another provider, and average revenue per customer jumps nearly 120 percent. If you add both broadband and joint-billed Cingular Wireless to the bundle, customers are more than 60 percent less likely to switch, and revenue jumps more than 350 percent."[173]
>
> BellSouth noted that its success in selling bundles "had led to a BellSouth Answers ARPU of ovewr $68."[174]
>
> Verizon stated last year: "In consumer, our approach to the marketplace is to focus on customer retention and loyalty, while increasing the average monthly revenue per customer through these new services and higher penetration of bundles and packages."[175]

144. As shown above and in Appendix E, the Bells have successfully marketed packages to customers as a result of leveraging their long distance authority and their expansion into data markets. Telecommunications service providers use various tactics to lock-in customers to those packages. Although some of these tactics may offer short-term consumer benefits, they also impose transaction costs if customers later wish to change service providers. Some of the tactics that deter migration include:

- offering discounts for one-year contracts, instead of month-to-month agreements,
- bundling necessary equipment with a long-term commitment,
- imposing early termination fees, and
- non-portability of features.

145. The New Jersey Division of Rate Counsel calculated a cost of $264 for customers who seek to avoid being "locked in" to their DSL service ("Lock-in Avoidance

[173] / AT&T 2005 Annual Report, at 10.

[174] / BellSouth Corporation, *BLS Investor News*, July 24, 2006, at 8.

[175] / Verizon Second Quarter 2005 Earnings Conference Call at 6.

Premium") for AT&T in reply comments filed in the Commission's *Consumer Protection in a Broadband Era* proceeding earlier this year:

> The Bells are uniquely positioned to offer comprehensive packages of telecommunications services to residential and small business customers. Their position is unique because (1) they are the most widely recognized provider of service in their operating territories; (2) the dominate the local market; (3) they have a pre-existing and long-term relationship with their customers; and (4) they have unique access to a vast customer base. The Bells can provide customers with bundled plans and essentially lock them into buying all telecommunications services, including local services, from one provider.[176]

146. The Bells offer various bundles of services, including several that include unlimited local usage and toll usage. Without access to comprehensive data about consumers' usage patterns (*e.g.*, local and toll usage), and interaffiliate transactions between the parent companies and the state operations, (e.g., cost and revenue information), one cannot assess whether anti-competitive behavior is occurring.

The bundling of competitive and non-competitive services, as well as interstate with intrastate services complicates regulatory oversight.

147. Although the Bells' one-stop shopping for its calling packages may offer customers the predictability and simplicity they seek, the Commission should be concerned because the Bells' packages include a blend of competitive services (long distance) and non-competitive services (unlimited local calling). This combination of competitive and non-competitive products raises significant issues about potential anti-

[176]/ *In the Matter of Consumer Protection in a Broadband Era*, FCC WC Docket No. 05-271, Reply Comments of the New Jersey Division of the Ratepayer Advocate, March 1, 2006, at 7-10.

competitive pricing behavior.[177] Furthermore, the Bells' packages blend interstate services with intrastate services, further complicating oversight and regulation.

148. Of course, in the short term, consumer choice increases consumer welfare because consumers can select the package that yields the greatest benefit within their budget constraints. However, in the long term, the critical question is whether adequate safeguards prevent cross-subsidization of competitive services by non-competitive ones. In the short term, this impressive array of options may benefit consumers, but if, in the long term, the Bells squeezes out their competitors, consumers are harmed by diminishing competitive choice.

149. Among other things, regardless of the outcome of this proceeding and the decisions the Commission ultimately makes with respect to reforming the jurisdictional separations rules, the FCC should analyze the following:

- Are the Bells compensating their state operations adequately for the use of their local network and brand recognition?

[177] / The New Jersey Division of the Rate Counsel (formerly Ratepayer Advocate) filed comments in the Commission's review of Qwest's petition for forbearance from dominant carrier rules stating the following:

> Concerns that the Ratepayer Advocate identified and discussed in its filing in WC Docket No. 02-112 and CC Docket No. 00-175 (concerning the sunsetting of BOC separate affiliate requirements) apply also in this proceeding. Specifically, local exchange carriers should continue to be subject to the requirements of the *Competitive Fifth Report and Order,* and, furthermore, these requirements should be imposed after the Section 272 requirements sunset to prevent anticompetitive and discriminatory behavior. Structural safeguards are critical because incumbent carriers, despite their assertions to the contrary, continue to possess market power in the relevant markets.

Qwest's Petition for Forbearance from Enforcement of the Commission's Dominant Carrier Rules as They Apply After Section 272 Sunsets, WC Docket No. 05-333, Comments of the New Jersey Division of the Ratepayer Advocate, January 23, 2006, at 14 citing Comments of the New Jersey Division of the Ratepayer Advocate, WC Docket No. 02-112, CC Docket No. 00-175, June 30, 2003.

- Are basic local exchange services customers who do not subscribe to packages receiving the same quality of service as customers of bundles receive?
- Are those business consumers of packages with unlimited usage being cross-subsidized by those businesses which do not opt for package?

Without data about consumers' actual average usage and information about the way in which Bells compensate state operations for use of the local network, one cannot assess whether cross-subsidization occurs.

150. If regulators continue to seek to encourage the development of local competition, they confront the challenge of ensuring that the Bells do not cross-subsidize competitive pursuits with non-competitive revenues or engage in discriminatory tying arrangements. This will likely require audits of inter-affiliate transactions and cost studies for the relevant products. Improved cost accounting tools are essential for regulators.

151. Also, bundled customers may ultimately become vulnerable to Bell pricing and service quality whims. As noted above, the transaction cost of migrating *from* a bundle is high, thus deterring customer churn.

RBOCs' increasing sales of bundled offerings inhibit regulators' ability to detect and to prevent anticompetitive pricing.

152. As noted above, many Bell-offered bundled services include intrastate and interstate products.[178] For example, Verizon's Freedom packages include local and long distance service with DSL and/or DIRECTV service and AT&T offers "Quad Pack" that bundles high-speed Internet, wireline voice (local and long distance), wireless and digital

[178] / See Appendix F which reproduces illustrative web pages.

satellite TV. Despite the enormous growth in demand for bundled services, the Bells have not been held accountable for the way in which they assign and allocate the costs and revenues of these packages. Insufficient assignment and allocation of costs to the interstate jurisdiction and insufficient assignment and allocation of revenues to the intrastate jurisdiction would create false revenue shortfalls at the state level, creating pressure on basic local exchange rates. Similarly insufficient allocation of costs to the unregulated lines of business for package components such as DSL would place undue pressure on regulated rates (whether state or federal). Furthermore, without adequate accounting tools, regulators cannot detect whether Bells are cross-subsidizing their competitive services with revenues from regulated services.

Regulators require detailed information about the assignment and allocation of costs and revenues for Bells' bundled offerings.

153. The Commission's inclusion of questions in its draft data request which, among other things, seeks descriptions of and revenue information for carriers' bundled packages is appropriate and essential.[179] However, as I discuss in Section V, the Commission should expand the data request to include additional information regarding bundled packages.

154. Regulators and consumer advocates need a more accurate picture of how the Bells are treating bundled services, what types of customers are subscribing to bundles and what types of customers are not, and trend data. For the instant proceeding, the Commission should review cost and revenue allocation information. I have included specific recommendations in Section V, which specifically address the draft data request.

[179] / *FNPRM,* at Appendix C: Draft Data Request, at J.

VIII. CONCLUSION

155. This section of my affidavit summarizes my major conclusions, based on the analysis and discussion set forth above.

Consumers of intrastate regulated services foot the bill for unregulated services or services that are jurisdictionally interstate.

156. Consumers of intrastate regulated services are bearing unfairly the cost of billions of dollars of carriers' investment in plant and related expenses that should be assigned and allocated to unregulated lines of business and interstate services.

157. The structure of the Commission's rules require first an allocation of costs between regulated and deregulated services. Then there is an allocation of costs between the interstate and the intrastate jurisdiction.[180]

Seismic changes warrant re-initialization of interstate and intrastate rates.

158. Numerous factors create a gross mismatch between the current accounting of revenues and costs including: the Bells' pursuit of unregulated lines of business; the Bells' increasing sales of long distance and bundled services which mingle intrastate, interstate, regulated, and unregulated products; the Commission's declaration that wireline broadband services are information services; the deployment of packet switches; and the jurisdictional shift of services such as VoIP and ISP-bound traffic that the Commission has said is interstate. These seismic changes justify a long overdue, close examination of costs and rates by federal and state regulators.

159. Distorted intrastate and interstate costs and their resultant rates demonstrate the compelling need for federal and state regulators to examine those costs and rates (1) to

[180] / Overriding this allocation process is the requirement that costs be strictly assigned to services whenever possible.

ensure that regulated services are not cross-subsidizing unregulated services and (2) to lower intrastate regulated rates based on an allocation and assignment of carriers' plant to interstate and unregulated operations that reflects current conditions.

States should not await the Commission's resolution of this complex proceeding before reducing excessive rates for intrastate regulated services.

160. Consumers' intrastate regulated rates are excessive: states should exercise their right to remove non-regulated activities from intrastate rates and to direct carriers to directly assign private line investment. As the Commission recognizes, "state jurisdictions have the ability to remove the costs of state non-regulated activities so that those costs will not be recovered in regulated intrastate rates."[181]

161. The Commission should, consistent with NARUC's resolution, "clarify that all carriers must continue to directly assign all private lines and special access circuits based on existing line counts."[182]

162. Delay in re-initializing excessive state rates harms consumers, and, therefore, states should not await the conclusion of this proceeding before examining carriers' costs. The Commission should issue an interim order removing any residual uncertainty about states' rights to remove the costs of non-regulated and interstate activities from intrastate rates.

Interstate regulated rates are likely excessive.

163. Carriers' forays into unregulated lines of business, which "free-ride" over a common platform (without bearing a commensurate share of common costs) likely yield

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[181] / *FNPRM*, at footnote 6.

[182] / *Id.*, at para. 92, citing *Resolution Relating to Separations Reform*, NARUC (February 15, 2006).

excessive interstate regulated rates. Therefore, the Commission should re-initialize interstate rates.

164. If carriers properly allocated and assigned costs to unregulated services, the subscriber line charge would likely decline. The Commission should reject the proposal set forth in the "Missoula Plan" to increase consumers' subscriber line charge unless and until a close examination of carriers' cost justify such an increase. Such an assessment depends critically on the Commission's findings about the Bells' exorbitant overearnings in the pending special access proceeding, and review of the Bells' assignment and allocation of costs to unregulated lines of business.

Regulators' delay in examining carriers' costs harms consumers.

165. Delay harms consumers. By perpetuating an outdated accounting system, and by postponing a detailed review of Bells' costs and revenues, the FCC is not meeting its responsibility to protect consumers.

166. Present rates are distorted and the present cost accounting rules are inadequate tools for detecting cross-subsidization and for assisting states in fulfilling their duty to ensure that rates are just and reasonable.

The Commission should debunk the carriers' myths at the outset.

167. Despite carriers' assertions to the contrary, neither existing levels of competition nor the existence of alternative forms of regulation protect consumers adequately from the distorted rates that are based on an outdated and/or insufficiently applied cost accounting system.

The Commission should reject BellSouth's petition for forbearance.

168. The Commission should reject BellSouth's petition for forbearance from cost allocation rules because, among other reasons, price cap regulation does not eliminate the need for cost accounting, competitive forces do not yet discipline BellSouth's regulated rates, and regulators' need for cost data outweighs any purported burden to BellSouth of providing such data.

The Commission should require carriers to demonstrate that UNE revenues and UNE costs are assigned to the same jurisdiction.

169. Bell operating companies offer unbundled network elements to CLECs under commercially negotiated arrangements, which are gradually replacing "vestige" UNE-platform ("UNE-P").[183] Bells' accounting of the cost and revenues associated with this line of wholesale business is unclear. The Commission should clarify the jurisdictional classification of unbundled network element ("UNE") revenues and costs. At a minimum, the Commission should direct carriers to assign revenues and costs to the same jurisdiction and to provide federal and state regulators with detailed evidence of compliance with this directive.

The Commission should take immediate steps to correct, at least in part, the information asymmetry that exists between the regulated entities and the regulators.

170. The Commission should issue a detailed data request in a timely manner, similar to that set forth in the *FNPRM,* with the modifications that I discuss above. The industry's responses to the request should be made available to consumer advocates and

[183] / As result of a federal regulatory decision that is widely perceived as favoring the Bells over CLECs, as of March 2006, incumbent local exchange carriers no longer offer UNE-P at rates based on total element long run incremental cost ("TELRIC"). *Triennial Review Remand Order*. CLECs must now enter commercial "negotiations" with ILECs should they seek access to ILECs' wholesale facilities. (Clearly, with each successive wave of Bell mergers, the shift of balance between the CLEC and the ILEC tips more in favor of the latter, rendering the commercial negotiation of rates, terms, and conditions between the incumbent and the entrant entirely lopsided.)

state regulators so that they can contribute to a collaborative federal-state approach to revising the outdated cost accounting rules.

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

Executed on August ____, 2006