



# QSI Consulting

## Impact Study

# AN ANALYSIS OF VERIZON'S PETITIONS FOR FORBEARANCE

*A Quantification of the Impact of Forbearance*

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# TABLE OF CONTENTS

Executive Summary .....	1
I. DESCRIPTION OF VERIZON’S FORBEARANCE PETITIONS .....	6
II. FORBEARANCE WILL IMMEDIATELY INDUCE UPWARD PRESSURE ON <i>WHOLESALE PRICES</i> .....	7
A. Pricing Provisions for Loops and Transport Offered Under 47 U.S.C. Section 251(c)(3) .....	8
B. Verizon Will Increase Wholesale Prices If Forbearance is Granted.....	8
1. Overview.....	8
2. CLECs Have Few, If Any, Economically-Viable Alternatives to Verizon’s Wholesale Facilities .....	8
3. The GAO Report Demonstrates that RBOC Pricing Flexibility Causes Upward Pressure on Prices .....	11
C. Comparison: Verizon’s Special Access Versus TELRIC-Based UNE Rates.....	12
III. WHOLESALE PRICE INCREASES INDUCE <i>RETAIL</i> PRICE INCREASES.....	14
A. Overview .....	14
B. Wholesale Price Increases Lead to CLECs Exiting Markets and/or Increasing Retail Prices .....	15
C. Granting Verizon Forbearance from TELRIC-Based Pricing of UNEs Would Create a Qualitative Change in the Nature of the Retail Market .....	16
D. Firms with Market Power – Such as Verizon – Are Willing and Able To Increase Profits by Raising <i>Retail</i> Prices and Forfeiting Larger Market Shares ...	17
E. The Elimination of a Retail Competitors Will Facilitate Collusive Conditions and Lead to Higher Retail Rates .....	18
1. The Elimination of CLECs Will Facilitate Coordinated Interaction Between Duopolists .....	19
2. Intermodal Competition is Not Price Constrained Competition.....	20
IV. DESCRIPTION OF <i>QSI IMPACT STUDY</i> METHODOLOGY .....	21
A. Study Methodology and Data .....	21
B. Results of <i>QSI Study</i> .....	24
V. CONCLUSION.....	27

## EXECUTIVE SUMMARY

In early 2008, Verizon filed two petitions requesting that the Federal Communications Commission (“FCC”) forbear the application of certain obligations to Verizon in the state of Rhode Island, and Virginia Beach Metropolitan Statistical Area (“MSA”).<sup>1</sup> Verizon requested in its forbearance petitions “substantially the same regulatory relief that the Commission granted in the [Qwest] Omaha Forbearance order...”<sup>2</sup> Verizon’s 2008 Petitions are essentially repackaged versions of Verizon’s 2006 Six-MSA Petitions<sup>3</sup> that the FCC denied in 2007,<sup>4</sup> with the main difference being that the 2008 Petitions concern a more narrow geographical scope: The Rhode Island 2008 Petition targets the Rhode Island portion of the Providence MSA (thus excluding the Massachusetts portion of the Providence MSA), while the Virginia Beach 2008 Petition targets portions of the Virginia Beach MSA served by Cox (thus excluding the portion of the Virginia Beach MSA not served by Cox).<sup>5</sup>

Verizon’s requested relief relates to a number of its obligations under the FCC’s rules,<sup>6</sup> including forbearance from wholesale loop and transport unbundling regulation pursuant

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<sup>1</sup> See Petition of the Verizon New England for Forbearance Pursuant to 47 U.S.C. in Rhode Island, WC Docket No. 08-24 (filed February 14, 2006) (Verizon Rhode Island Petition); § 160(c) Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in Cox’s Service Territory in the Virginia Beach Metropolitan Statistical Area, WC Docket No. 08-49 (filed March 31, 2008) (Verizon Virginia Beach Petition) (collectively, “Verizon 2008 Petitions”).

<sup>2</sup> Verizon 2008 Petitions, p. 1.

<sup>3</sup> See Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Boston Metropolitan Statistical Area, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Boston Petition); Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the New York Metropolitan Statistical Area, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon New York Petition); Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Philadelphia Metropolitan Statistical Area, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Philadelphia Petition); Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Pittsburgh Metropolitan Statistical Area, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Pittsburgh Petition); Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Providence Metropolitan Statistical Area, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Providence Petition); Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Virginia Beach Metropolitan Statistical Area, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Virginia Beach Petition) (collectively, “Verizon 2006 Six-MSA Petitions”).

<sup>4</sup> Petitions of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Boston, New York, Philadelphia, Pittsburgh, Providence and Virginia Beach Metropolitan Statistical Areas, WC Docket No. 06-172 *Memorandum Opinion And Order* Adopted December 4, 2007.

<sup>5</sup> The geographic areas identified in Verizon’s 2008 Petitions comprise the majority of Providence and Virginia Beach MSAs. We refer to Verizon’s 2008 Petitions as “two-MSA” petitions for simplicity and also because the economic impact of granting Verizon’s Petitions would affect the whole MSAs.

<sup>6</sup> Verizon seeks forbearance from (1) loop and transport unbundling obligations pursuant to Section 251(c) of the Telecommunications Act; (2) Part 61 dominant carrier tariffing requirements; (3) Part 61 price cap regulations; (4) *Computer III* requirements including CEI and ONA requirements; and (5) dominant carrier requirements arising under Section 214 of the Act and Part 63 of the FCC’s rules concerning the processes for acquiring lines, discontinuing services, assignment or transfers of control, and acquiring affiliations.

to Section 251(c)(3) of the Communications Act of 1934, as amended (“Act”)<sup>7</sup> and from interstate switched access regulations. Granting Verizon’s Petitions as they relate to unbundling obligations means that loop and transport facilities would no longer be required to be made available to Verizon’s competitors in local exchange markets at Total Element Long Run Incremental Cost (“TELRIC”)-based rates, which are the rates designed to replicate a competitive market for these wholesale services and produce conditions that promote competition in retail local markets.

A grant of Verizon’s Petitions would impact regional markets in the two MSAs in a number of ways. The immediate impact would be an increase in wholesale prices faced by various competitive local exchange carriers (“CLECs”) and other local carriers that rely in whole or in part on Verizon’s loop and transport unbundled network elements (“UNEs”) and/or interconnection services. Similarly, the requested relief from interstate switched access rate regulation would increase wholesale prices of long-distance carriers because they rely on switched access service to originate and complete long-distance calls. Increases in wholesale rates would translate into increases in retail (end-user) rates for local and long-distance telephone and Internet services. Further, because of the recent trend for traditional incumbent and competitive telephone companies to offer video services and the convergence of voice, Internet and video markets, a grant of Verizon’s forbearance would affect the video markets. Increased wholesale rates not only would weaken competitors who rely on Verizon’s wholesale services, but would also increase Verizon’s revenue and strengthen its positions in relation to all other competitors (for example, cable companies). Finally, because a grant of forbearance would affect regional businesses, due to results ranging from a direct negative impact on regional CLECs (affecting employment and investment in the wholesale telecommunications market) and induced effects of higher overall price levels in retail telecommunications and non-telecommunications markets, the regional economies of the affected areas would experience a decrease in their competitiveness relative to the competitiveness of other regions in the United States and the world.

The *QSI Study*<sup>8</sup> focuses on the direct and quantifiable impact of granting Verizon’s Petitions as they relate to loop and transport unbundling obligations under Section 251 of the Act. More specifically, if Verizon is no longer required to make available loop and transport facilities at TELRIC-based rates, wholesale prices – *i.e.*, the cost of doing business for Verizon’s competitors – would increase. Because the ability of competitive entrants to buy essential network facilities at economic cost has created a disciplining force for retail telecommunications prices, forbearance would, in turn, cause an increase in prices for telecommunications services to consumers in the two MSAs affected by Verizon 2008 Petitions. Current pricing trends and Regional Bell Operating Company (“RBOC”) proposals indicate that absent the TELRIC pricing standard, prices of

<sup>7</sup> 47 U.S.C. § 251(c)(3).

<sup>8</sup> This QSI Study is an expanded and refined version of the QSI Study undertaken two years ago to evaluate the impact of granting Verizon’s Six-MSA Petitions. Refinements include the use of more up-to-date data, increased granularity of analysis with the focus on Rhode Island and Virginia Beach, as well as the addition of the residential video market.

Verizon's network elements would be at least at the level of its special access prices. This follows from experience with the incumbent local exchange carriers' ("ILECs") reactions to previous changes in unbundling requirements. Competitors that currently rely on Verizon's loop and transport UNEs can expect to pay Verizon's special access rates for the same facilities if the Petitions are granted.<sup>9</sup> Because special access prices are significantly higher than TELRIC-based prices, higher wholesale rates would impair the ability of competitors – and potential entrants – to discipline retail rates.

Furthermore, as observed by a U.S. Government Accountability Office ("GAO") Report,<sup>10</sup> ILECs are increasing special access prices in MSAs where they have been granted full pricing flexibility for these services. The GAO's findings demonstrate that a predictable increase in wholesale prices will necessarily place upward pressure on retail/end user prices. Further, given that our analysis is predicated on current special access rates, the GAO's findings also show that our results are conservative for MSAs in which Verizon has been granted special access pricing flexibility, since in the absence of TELRIC-based UNE pricing, those special access rates are likely to go up in the near future if the FCC grants Verizon's Petitions.<sup>11</sup> That is, we have not captured the effects of these second-round price increases, which would lead to further increases in retail telecommunications expenditures.<sup>12</sup>

To determine the impact of a grant of forbearance for loop and transport unbundling obligations, we built a "bottom up" model to capture the competitive dynamics (*e.g.*, supply and demand responses) of the telecommunications markets in the two MSAs at issue based on the assumption that loop and transport facilities are no longer available at TELRIC rates in the state of Rhode Island and Virginia Beach MSA and must be purchased out of Verizon's special access tariffs. The impact of this change was then quantified as the absolute increase in annual telecommunications outlay incurred by retail telecommunications and video customers in Rhode Island and the Virginia Beach MSA.

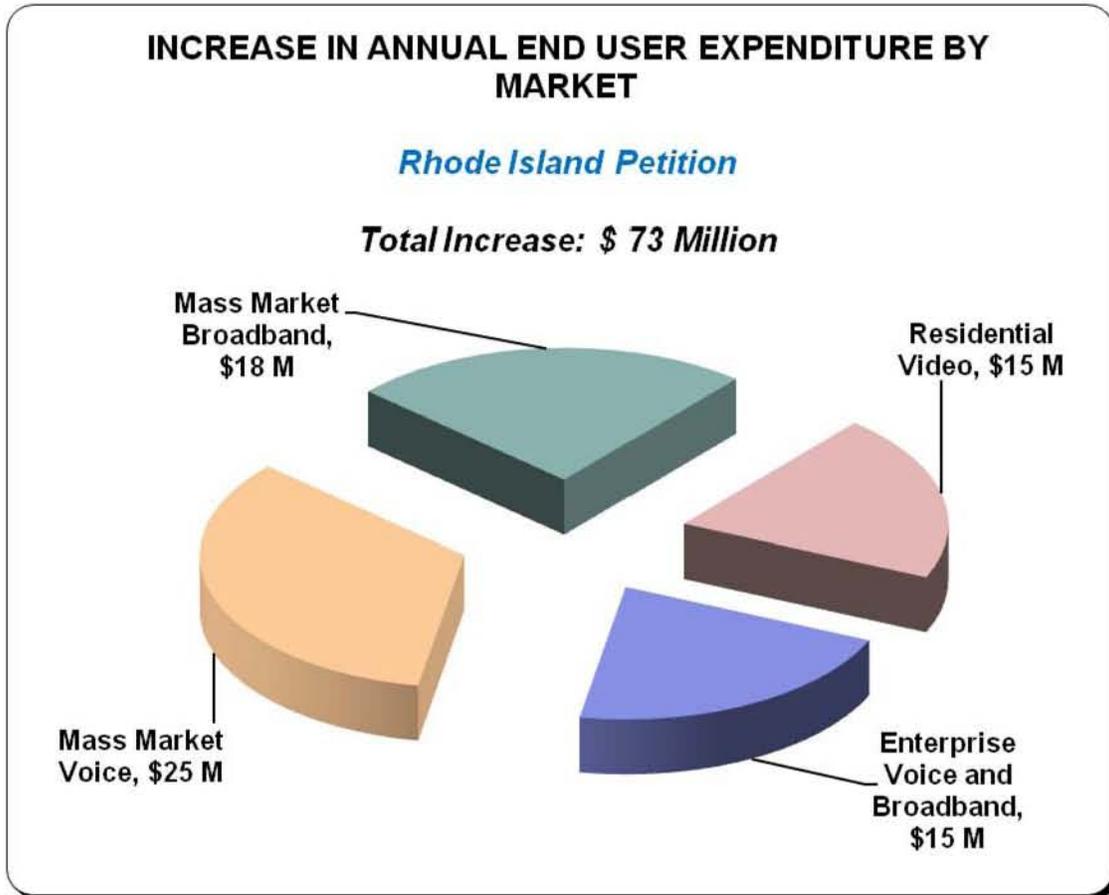
<sup>9</sup> For example, in Maine PUC Docket No. 2002-682, Verizon took the position that its Section 271 obligation is fulfilled by making Section 271 checklist items available at special access rates. *See Opposition to Verizon's Petitions of ACN, Alpheus, ATX, Broadwing, Cavalier, CityNet, CloseCall, CTSI, DSLnet, InfoHighway, Globalcom, ITC^DeltaCom, McLeodUSA, Mpower, Norlight, Penn Telecom, RCN, RNK, segTEL, Talk America, TDS Metrocom, and Telepacific*, WC Docket No. 06-172 (filed Mar. 6, 2007), at 39 ("ACN, *et al.*, *Opposition*"). Further, special access loop and transport products became a substitute for high-capacity UNE loops and transport in wire centers that were given a status of non-impaired under the FCC's Triennial Review Remand Order ("TRRO"). *See, e.g.*, Qwest's proposal for Section 271 pricing in Minnesota. *In the Matter of a Potential Proceeding to Investigate the Wholesale Rate Charged by Qwest*, Docket #P-421/CI-05-1996.

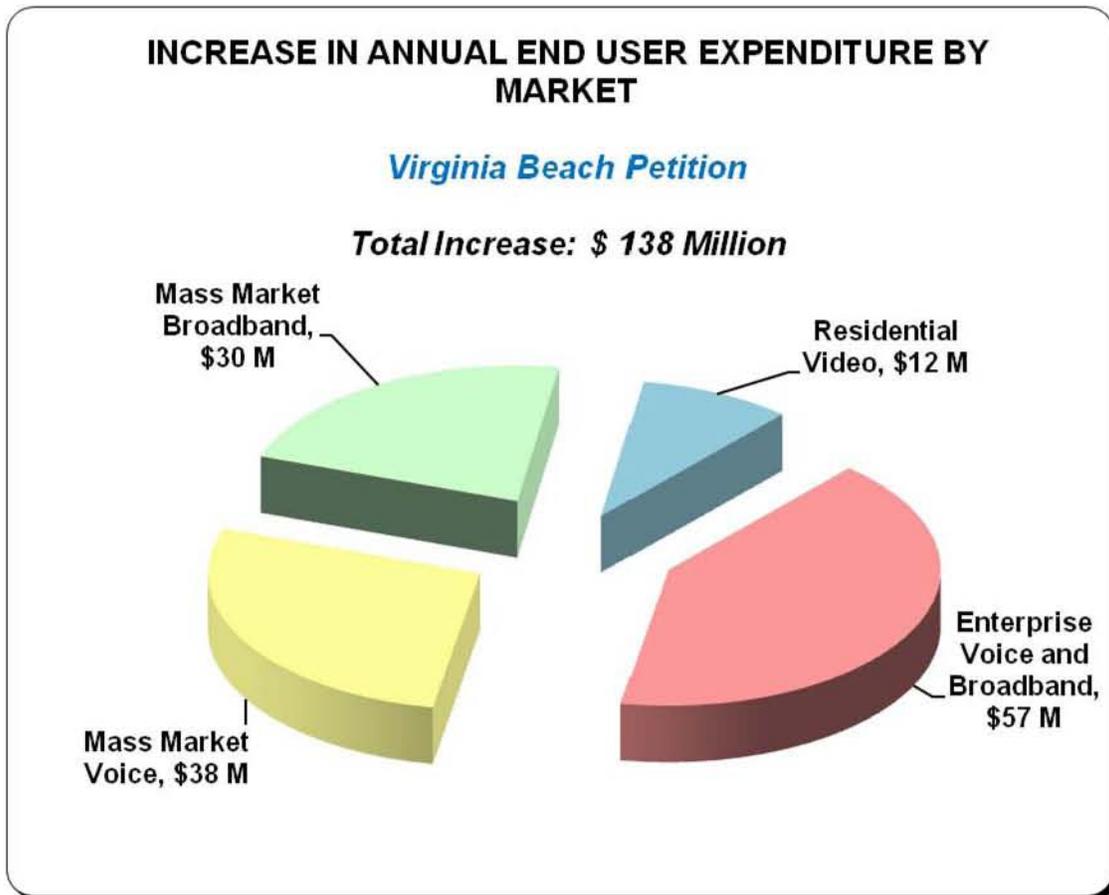
<sup>10</sup> United States Government Accountability Office, Report to the Chairman, Committee on Government Reform, House of Representatives, *Telecommunications: FCC Needs to Improve Its Ability to Monitor and Determine the Extent of Competition in Dedicated Access Services*, November 2006 ("GAO Report").

<sup>11</sup> Verizon has special access pricing flexibility for transport in both Rhode Island and Virginia Beach and pricing flexibility for loops in the Virginia Beach MSA.

<sup>12</sup> We have not reflected the impact of likely increases in Verizon's non-recurring charges for network elements or switched access rates. This is another reason why our impact analysis is conservative.

We have estimated this impact by affected MSA and by product market (including residential voice, broadband and video, small business voice and broadband and enterprise markets). The charts below summarize the estimated increases in annual retail expenditures by MSA for each of these market segments.





Based on reasonable, conservative assumptions regarding pricing strategies, demand responses, and market dynamics, we estimate that if the FCC grants Verizon its requested forbearance in the state of Rhode Island and Virginia Beach MSA, then the annual impact in terms of increased telecommunications expenses incurred by customers for retail mass market and enterprise voice and Internet services, as well as residential video would be approximately \$210 million *annually*, including \$73 million associated with the Rhode Island Petition, and \$138 million associated with the Virginia Beach Petition.<sup>13</sup> This translates into a residential expenditure increase of \$66 annually for an average household, and a 14% increase in business retail expenditures on wireline communications across the two MSAs.

<sup>13</sup> Numbers do not add due to rounding. One may also consider the offsetting benefits associated with the *increased profits* that Verizon will be able to extract from these MSAs. In such an analysis, increased profits would be counted on the plus side of an impact analysis. But, while in general corporate profits are a positive event, in the current context it is more appropriate to not recognize an increase in Verizon's corporate profits because those profits would be achieved simply by regulatory fiat – at the expense of end user customers – and would not signify improved efficiencies or other advances generally viewed as genuinely positive and desirable for society. Our approach is further justified by the fact that Verizon makes no demonstration in its Petitions that forbearance is required because of inadequate earnings.

## I. DESCRIPTION OF VERIZON'S FORBEARANCE PETITIONS

In its two Petitions, Verizon seeks “substantially the same regulatory relief that the Commission granted in the [Qwest] Omaha Forbearance order...”<sup>14</sup> More specifically, Verizon is seeking forbearance from the following:

1. Loop and transport unbundling obligations pursuant to Section 251(c)(3) of the Act;
2. Part 61 dominant carrier tariffing requirements;
3. Part 61 price cap regulations;
4. *Computer III* requirements including CEI and ONA requirements; and
5. Dominant carrier requirements arising under Section 214 of the Act and Part 63 of the FCC's rules concerning the processes for acquiring lines, discontinuing services, assignment or transfers of control, and acquiring affiliations.

This paper will focus on the ramifications of forbearance from the first item: loop and transport unbundling obligations pursuant to Section 251(c)(3) of the Act.

Under the *Omaha Forbearance Order*, Qwest is no longer required to provide unbundled access to loop and transport UNEs pursuant to Section 251(c)(3) in nine wire centers located in the Omaha, Nebraska MSA.<sup>15</sup> Our analysis assumes that if Verizon's Petitions are granted as they relate to Section 251(c)(3) unbundling obligations, Verizon, like Qwest in certain wire centers within the Omaha MSA, would no longer be required to provide unbundled access to loops and transport facilities in the state of Rhode Island and Virginia Beach MSA.

Verizon's 2008 Petitions are essentially repackaged versions of Verizon's 2006 Six-MSA Petitions<sup>16</sup> that the FCC denied in 2007,<sup>17</sup> with the main difference being that the 2008

<sup>14</sup> Verizon 2008 Petitions, p. 1.

<sup>15</sup> *Petition of Qwest Corporation for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Omaha Metropolitan Statistical Area*, Memorandum Opinion and Order, 20 FCC Rcd 19415 (2005) (“*Omaha Forbearance Order*”), at ¶ 2, *aff'd Qwest Corporation v. Federal Communications Commission*, Case No. 05-1450, (D.C. Cir. Mar. 23, 2007) (“*Qwest Omaha*”).

<sup>16</sup> See *Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Boston Metropolitan Statistical Area*, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Boston Petition); *Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the New York Metropolitan Statistical Area*, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon New York Petition); *Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Philadelphia Metropolitan Statistical Area*, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Philadelphia Petition); *Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Pittsburgh Metropolitan Statistical Area*, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Pittsburgh Petition); *Petition of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Providence Metropolitan Statistical Area*, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Providence Petition); *Petition of the Verizon Telephone Companies for*

Petitions concern a more narrow geographical scope: the Rhode Island 2008 Petition targets the Rhode Island portion of the Providence MSA (thus excluding the Massachusetts portion of the Providence MSA), while the Virginia Beach 2008 Petition targets portions of the Virginia Beach MSA served by Cox (thus excluding the portion of the Virginia Beach MSA not served by Cox). The geographic areas identified in Verizon's 2008 Petitions comprise the majority of Providence and Virginia Beach MSAs. We size the impact of Verizon's 2008 Petitions for the two MSAs affected by these petitions (Providence and Virginia Beach) for simplicity and also because the economic impact of granting Verizon's Petitions would affect the entire MSAs. Specifically, as explained by several commenters, an MSA is the best definition of the relevant geographic market because MSA boundaries are defined to capture the areas with high degree of economic integration and because competitive entry occurs on the level of MSAs.<sup>18</sup> In other words, while Verizon's Petitions appear to concern only portions of an MSA (the majority portions), their impact would be observed in the whole MSA. Therefore, we present the results of our analysis in terms of a MSA-level impact.<sup>19</sup>

## II. FORBEARANCE WILL IMMEDIATELY INDUCE UPWARD PRESSURE ON WHOLESAL E PRICES

Wholesale prices for unbundled loop and transport facilities purchased from Verizon pursuant to Section 251 of the Act are based on the TELRIC pricing standard. If Verizon's Petitions, as they relate to unbundling obligations, are granted, the same loop and transport facilities will no longer be available at TELRIC-based prices; rather, carriers will be forced to purchase these facilities under different terms, conditions, and rates, most likely those of Verizon's special access tariff.

Forbearance Pursuant to 47 U.S.C. § 160(c) in the Virginia Beach Metropolitan Statistical Area, WC Docket No. 06-172 (filed Sept. 6, 2006) (Verizon Virginia Beach Petition) (collectively, "Verizon 2006 Six-MSA Petitions").

<sup>17</sup> Petitions of the Verizon Telephone Companies for Forbearance Pursuant to 47 U.S.C. § 160(c) in the Boston, New York, Philadelphia, Pittsburgh, Providence and Virginia Beach Metropolitan Statistical Areas, WC Docket No. 06-172 *Memorandum Opinion And Order* Adopted December 4, 2007.

<sup>18</sup> See Telecom Investors' Opposition To Verizon's Petition, WC Docket No. 08-49, May 13, 2008 ("Telecom Investors' Opposition, WC Docket WC 08-49") pp. 14-15 (citing the FCC determination that MSAs best capture the scope of competitive entry) and Cavalier Telephone, LLC's Opposition To Verizon's Petition For Forbearance, WC Docket No. 08-49, May 13, 2008 p. 9. See also One Communications, Corp, tw telecom inc., Integra Telecom, Inc. and Cbeyond, Inc. April 14, 2009 Ex Parte in WC docket No. 08-49, "Factual and Legal Support for Competitors Proposed UNE Forbearance Standard," ("One Communications et al. April 14, 2009 Ex Parte in WC docket No. 08-49"), pp. 9-11 explaining that CLEC entrance occurs on a MSA level because smaller geographical divisions do not provide a viable scale for CLEC entry.

<sup>19</sup> At the same time we *calculate* the impact based on the narrower geography identified in the Verizon Petitions. For example, while the Providence MSA occupies the state of Rhode Island and portions of Massachusetts, our analysis assumed that if forbearance is granted, the increase in wholesale cost would be observed only in the Rhode Island portion of the Providence MSA.

## **A. Pricing Provisions for Loops and Transport Offered Under 47 U.S.C. Section 251(c)(3)**

Under the FCC's TELRIC methodology, prices are to be set at the forward-looking economic cost. The economic reason – as expressed by the FCC – for setting the prices for loops and transport offered under Section 251(c)(3) at cost (*i.e.*, TELRIC) is to emulate competitive markets (which tend to drive prices to economic cost) and to provide the appropriate price signals to all market participants.<sup>20</sup> The FCC has concluded that prices based on cost (in particular, forward-looking economic costs) are consistent with this public policy objective.

The availability of wholesale facilities at TELRIC-based rates plays a critical role in disciplining retail markets. An increase in wholesale rates, which forbearance would bring about, is certain to impair this disciplining function of competitors – *and would-be competitors* – and fundamentally alter the competitive dynamic in retail markets.

## **B. Verizon Will Increase Wholesale Prices If Forbearance is Granted**

### **1. Overview**

As discussed above, if the FCC grants Verizon's Petitions, Verizon will no longer be required to make its loop and transport network elements available at TELRIC-based UNE rates. Verizon, like other RBOCs, has advocated that CLECs obtain these network elements out of Verizon's special access tariffs instead. Because there are few if any economically-viable alternatives to Verizon's loop and transport facilities, this means that CLECs will face the higher wholesale prices that Verizon's tariffed special access offerings constitute.

### **2. CLECs Have Few, If Any, Economically-Viable Alternatives to Verizon's Wholesale Facilities**

CLECs' extensive use of Verizon's facilities today is driven by the fact that, particularly in the short and intermediate run, CLECs have no economically-viable alternatives.

<sup>20</sup> *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd 15499 (1996), at ¶ 360 (“*Local Competition Order*”), aff'd in part and vacated in part sub nom. *Comp. Tel. Assoc. v. FCC*, 117 F.3d 1068 (8<sup>th</sup> Cir. 1997) and *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8<sup>th</sup> Cir. 1997), aff'd in part and remanded, *AT&T v. Iowa Utils. Bd.*, 525 U.S. 366 (1999); on remand *Iowa Utils. Bd. v. FCC*, 219 F.3d 744 (8<sup>th</sup> Cir. 2000), reversed in part sub nom. *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002), at ¶ 679.

To economically justify self provisioning facilities, CLECs must consider the demand and the anticipated rate of utilization of the facilities for a specific route. For example, a CLEC must typically expect at least 9 to 12 DS3 transport circuits on a route in the near term to economically justify self provisioning a route.<sup>21</sup> This means that construction of interoffice facilities by multiple CLECs will generally be found only on the very densest traffic routes. The economics of building one's own loop facilities are even more challenging. Specifically, a CLEC will generally require traffic demand requiring approximately three DS3 loops under contract at a particular location before it can economically justify the substantial investment in construction of its own loop facility to that business location.<sup>22</sup> Customers with this level of demand are very rare. Very few business customers are served with even one DS3 loop, much less three. Thus, while CLECs do own and operate their own loop and transport facilities in some circumstances, these limited facilities are location-specific and do not represent substitutes for the Verizon facilities that CLECs continue to rely upon. Further, since there are very few CLEC loops to commercial buildings (relative to the number of commercial buildings served), CLECs' ability to utilize loop facilities deployed by other CLECs is scarce.

To the extent CLECs have their own transport facilities, there are a number of problems that limit the viability of these CLEC facilities for use by other CLECs. A third-party carrier is unlikely to be able to provide all of the routes a CLEC would need in a metro area. Therefore, the decision to use a third-party carrier likely would require a CLEC to obtain and manage services obtained from multiple suppliers and the CLEC may have to build into the third-party carriers' locations in order to connect to its own switch site. When a CLEC decides to obtain facilities from multiple suppliers, it becomes more difficult to monitor and maintain service quality, and maintenance and repair issues may pose problems.<sup>23</sup> Also, the CLEC must establish and maintain cross-connects between the collocation arrangements to access the third party services/facilities, which may be expensive and obviate any perceived advantages of obtaining facilities from a third party. Finally, even if another CLEC has interoffice transport services available, it typically will not be willing to offer these facilities on a wholesale basis to a would-be competitor.

Importantly, cable operators do not present an economically-viable alternative to Verizon's wholesale loop and transport network elements for a variety of reasons. First, cable television systems are not typically designed to provide these types of services, and cable companies do not offer a wholesale loop or transport product to CLECs over cable

<sup>21</sup> See, e.g., Declaration of Ajay Govil on behalf of XO Communications, LLC, *Minnesota Public Utilities Inquiry Regarding Petition of Qwest Corporation, Filed with the Federal Communications Commission, for Forbearance Pursuant to 47 U.S.C. Section 160(c) in the Minneapolis-St. Paul Minnesota Metropolitan Statistical Area*. MPUC Docket No.: P421/CI-07-661 (filed Aug. 16, 2007).

<sup>22</sup> *Id.*

<sup>23</sup> As pointed out in *One Communications et al.* April 14, 2009 Ex Parte in WC Docket No. 08-49, p. 17, the transaction costs associated with establishing and maintaining multiple wholesale relationships are typically not justified.

television plant.<sup>24</sup> In fact, QSI is not aware of any instances in which a CLEC has substituted ILEC UNEs for cable provided services other than on an incidental basis. Next, cable companies have not and probably will never build the extensive operational support systems (“OSS”) the ILECs were required to put in place to meet their obligations under Section 251 of the Act. Such systems, however, are essential to a smooth and efficient provisioning process and it is difficult to see how in the absence of comparably efficient OSS CLECs could ever use cable facilities as economically viable substitutes for ILEC UNEs. Further, the traditional cable networks and the needs of most CLECs do not necessarily overlap. CLEC customers often are businesses and, consequently, the CLECs’ fiber optic backbones are found in business districts. By contrast, most cable television systems are built to serve residential customers in suburban areas. This means that the cable networks typically do not reach or connect to many of the CLECs’ target business customers.<sup>25</sup> Lastly, even if a cable network were to reach the CLECs’ business customers, the cable network is not necessarily constructed to reliably serve most business customers.<sup>26</sup>

Likewise, wireless services are not yet a viable wholesale alternative for either residential or business customers. This is in part because, overall, fixed and, particularly, commercial mobile wireless wholesale services do not today consistently provide the bandwidth, functionalities, or reliability at a comparable price to the wireline services that typically are required by CLECs serving residential customers, and most certainly for businesses customers. Further, wireless connections cannot today match the needs of the triple play offerings (voice, High-Speed Internet Broadband and video) that are becoming a “must have” for successful competition with Verizon FiOS and cable companies residential offerings. While this may change in the future, today wireless loop technology is clearly not a close substitute to Verizon’s wireline DS-1 and DS-3 loop facilities.

<sup>24</sup> See, e.g., Letter from Chris MacFarland, McLeodUSA, to the Marlene H. Dortch, Secretary, Federal Communications Commission (Dec. 15, 2006), attached as Exhibit D to Opposition of Cavalier Telephone Subsidiaries, WC Docket No. 06-172 (Mar. 5, 2007) (“*Cavalier Opposition*”) (“McLeodUSA has approached Cox Communications on at least two occasions regarding its willingness to entertain a commercial arrangement for McLeodUSA to lease from Cox last mile network facilities. McLeodUSA was rebuffed on both occasions.”).

<sup>25</sup> See, e.g., Comments of Cox Communications, Inc., WC Docket No. 06-172 (filed Mar. 5, 2007), at 6 (explaining that although it is a facilities-based company, Cox needs to lease Verizon’s sub-loops to reach customers in Multiple Tenant Environments).

<sup>26</sup> The cable networks may be constructed to support infrequent bursts of high speed data associated with cable modems as opposed to more continuous demand of high capacity business services. See One Communications et al. April 14, 2009 Ex Parte in WC Docket No. 08-49, pp. 13-15 explaining that compared to residential customers, networks serving business customers should accommodate higher usage demand, additional needs for redundancy, support calling features not offered to residential customers (such as call hunting and remote call forwarding). Similarly different is the customer acquisition and customer care procedures, which require a highly personalized service when dealing with business customers.

In sum, there is no functioning wholesale market sufficiently robust to curtail Verizon's incentive and ability to raise wholesale prices for loop and transport network elements if its Petitions are granted.

### 3. The GAO Report Demonstrates that RBOC Pricing Flexibility Causes Upward Pressure on Prices

As noted, several years ago the GAO examined price movements in special access markets after the FCC granted pricing flexibility to the RBOCs based on the assumption that these markets were sufficiently competitive to restrain RBOC market power.<sup>27</sup> The GAO's analysis goes well beyond any analysis performed by the FCC or by any other entity. As such, the market dynamics and the pricing trends identified in the GAO Report are reliable guideposts for what is most likely to transpire if the FCC were to grant Verizon's requests for forbearance and the additional pricing flexibility inherent therein.

Specifically, the GAO Report concluded:

Available data suggest that incumbents' list prices and average revenues for dedicated access services have decreased since 2001, resulting from price decreases due to regulation and contract discounts. *However, in areas where FCC granted full pricing flexibility due to the presumed presence of competitive alternatives, list prices and average revenues tend to be higher than or the same as list prices and average revenues in areas still under some FCC price regulation.* According to the large incumbent firms, many large customers needing service in areas with pricing flexibility purchase dedicated access services under contracts that provide additional discounts. However, GAO found that contracts do not generally affect the differential cited previously, and that contracts also contain various conditions or termination penalties competitors argue inhibit customer choice. Government agencies, to the extent that they purchase dedicated access off of General Services Administration contracts, are generally shielded from price increases due to pre-negotiated rates. However, not all agencies purchase off of these contracts.<sup>28</sup>

These and other findings and conclusions in the GAO Report indicate loops and transport, the services subject to Verizon's Petitions, are offered in markets that remain highly concentrated; *i.e.*, these markets are dominated by a few large players that

<sup>27</sup> In this context, the term market power is used to indicate that a firm has the ability to profitably raise prices above competitive levels for a sustained period of time.

<sup>28</sup> GAO Report, at 1 (emphasis supplied).

continue to be able to push prices upward above competitive (reasonably cost-based) levels.

In sum, and for purposes of the analysis at hand, the GAO Report is a clear and definitive demonstration that Verizon's requested relief from the TELRIC pricing requirements would generally translate into upward pressure on wholesale prices for network elements used by competing CLECs. If there is not sufficient competitive pressure to keep Verizon from increasing its special access prices when it has the regulatory flexibility to do so, there is no reason to believe that there is sufficient competitive pressure to prevent Verizon from increasing the prices for its loop and transport facilities to, at a minimum, its special access prices with a grant of forbearance.<sup>29</sup>

### **C. Comparison: Verizon's Special Access Versus TELRIC-Based UNE Rates**

As noted above, the *QSI Study* is driven by the increases in Verizon's wholesale rates from TELRIC-based UNE rates to current special access rates. To model these rate increases, QSI accounted for a number of complicating factors such as the rate variance across rate/density zones; term discounts; distance/mileage sensitive rates and the unavailability of high-capacity UNE loop and transport elements in certain wire centers as a result of the *TRRO*.<sup>30</sup>

The following charts illustrate the difference between Verizon's recurring UNE and special access rates by area.<sup>31</sup>

<sup>29</sup> It is important to note that special access pricing has been kept in line by the availability of TELRIC-priced UNEs and in the absence of UNEs special access prices are very likely to rise.

<sup>30</sup> *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, Order on Remand, 20 FCC Rcd 2533 (2005) ("*TRRO*"), *affirmed Covad Communications v. FCC*, 450 F.3d 528 (D.C. Cir. 2006).

<sup>31</sup> For rates that vary by rate zone or band, the charts depict an average of the highest and lowest banded/zoned rates. Special access rates account for the specific pricing flexibility status of each relevant MSA. Transport rates include per termination and mileage-sensitive components aggregated via an assumption of a 10 mile transport. For special access rates with term discounts month-to-month rates were utilized because they present a closer substitute to UNEs (for which no term discounts apply) than term rates.

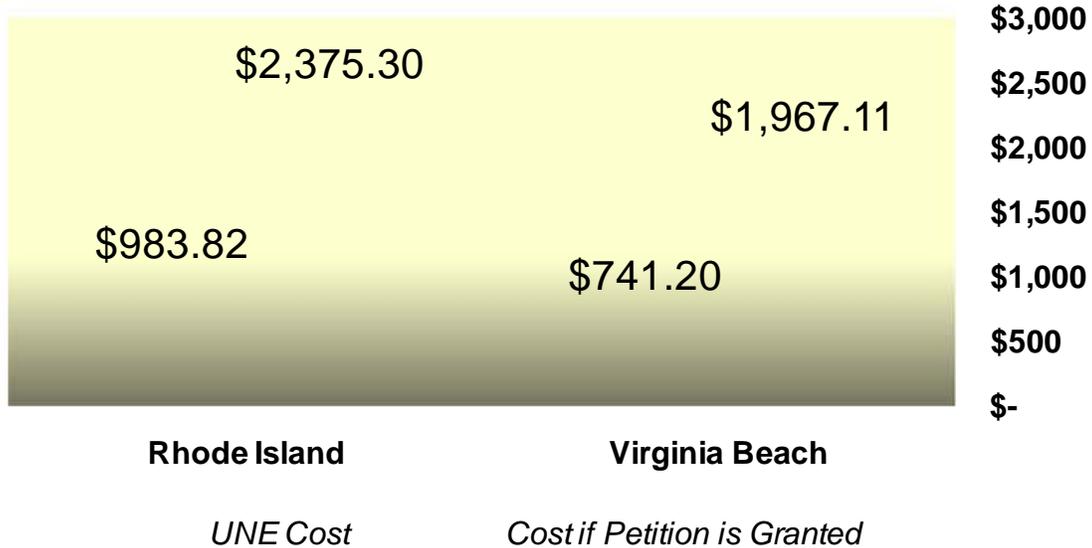
**DS1 Loops:  
UNE Cost and Cost if Forbearance is Granted  
(Recurring per Month)**



**DS1 Transport:  
UNE Cost and Cost if Forbearance is Granted  
(Recurring per Month)**



**DS3 Transport:  
UNE Cost and Cost if Forbearance is Granted  
(Recurring per Month)**



As seen in the above charts, the differences between Verizon’s recurring UNE and special access rates for the loop and transport network elements is significant. On average across the two Petition areas, current special access rates for 2-wire and DS1 loops are almost *two times higher* than UNE rates. The increase is even more pronounced for transport, with special access rates being *more than three times higher* than UNEs for DS1 transport, and *more than 2.5 times higher* than UNEs for DS3 transport on average across the two Petition areas.

**III. WHOLESALE PRICE INCREASES INDUCE *RETAIL* PRICE INCREASES**

**A. Overview**

As discussed in the previous Sections, one effect of a grant of forbearance will be an increase in Verizon’s wholesale prices charged to its retail competitors, the CLECs. In response to these wholesale price increases, CLECs may seek to flow through these cost increases to their end-user customers in order to maintain their levels of profitability. To the extent that market conditions may prevent them from fully and proportionately raising end-user/retail rates (either immediately or over time), CLECs will have to absorb some (or all) of the wholesale price increases. CLECs that operate on the narrow edge of

profitability and are unable to either flow through or absorb wholesale price increases may be forced to exit the market, either by shrinking their operations and exiting one or more MSAs or by ceasing operations altogether.<sup>32</sup> One real-world example is found in the Omaha MSA where McLeod had to scale back their presence in that market<sup>33</sup> and another CLEC – Integra – aborted its plans to enter the Omaha market because of forbearance.<sup>34</sup> Be that as it may, the increases in wholesale rates will induce significant upward pressure on the end-user/retail rates of virtually all CLECs.

In what follows, we will discuss in more detail the CLECs' pricing responses and the responses from other market participants, such as Verizon, the cable companies, and others. We will discuss why the high degree of concentration in telecommunications markets and the limited ability and interest of intermodal competitors will permit the general level of retail prices to move upward as a result of CLEC-initiated price increases.

## **B. Wholesale Price Increases Lead to CLECs Exiting Markets and/or Increasing Retail Prices**

If the FCC grants Verizon's Petitions as they relate to unbundling obligations pursuant to Section 251 of the Act, a series of interrelated actions by telecommunications market participants would be set into motion. First and foremost, Verizon would increase its wholesale prices to CLECs.

To fully understand the effects of this change, it is important to understand the *initial* predicament of CLECs when Verizon increases wholesale prices for its network elements.<sup>35</sup>

The predicament in which a grant of forbearance will place CLECs is traditionally known as a "price squeeze."<sup>36</sup> To defeat the detrimental impact of wholesale price increases on their bottom line, CLECs will seek to increase their end-user rates. It is this initial

<sup>32</sup> Of course, there are many variations in the scenarios that may occur. Nevertheless, the permutations involve combinations of three basic responses: the CLEC either (1) absorbs the wholesale price increase; (2) flows through the wholesale price increase to end users; or (3) withdraws from the market.

<sup>33</sup> See Petition For Modification of McleodUSA Telecommunications Services, Inc. in docket No. WC 04-223 (Qwest Omaha Petition), July 23, 2007, p. 14.

<sup>34</sup> Comments of Integra Telecom, Inc. in WC Docket No. 06-172 (filed Mar. 5, 2007), p. 3.

<sup>35</sup> Not all CLECs use Verizon's facilities to the same degree, but virtually all CLECs operating in Verizon territory use some Verizon facilities. The QSI Model reflects the various degrees to which CLECs may be impacted.

<sup>36</sup> For a more formal definition, see Jean Tirole, "The Theory of Industrial Organization," The MIT Press, Cambridge, Massachusetts, 1988, at 186 ("Considering a situation in which a monopoly supplier is integrated downstream, a price squeeze [is] the situation in which the monopoly input supplier charges a price for the input to its downstream competitors that is so high they *cannot profitably* sell the downstream product in competition with the integrated firm.").

impetus to raise prices in response to Verizon's increase in wholesale rates that will cause ripple effects by inducing other market participants to raise their prices in turn. While in well functioning markets, such efforts would be penalized by customers migrating to lower-priced competitors, this is unlikely to occur in the six MSAs at issue for a number of reasons. First, the GAO Report conclusively demonstrated that these markets lack the competitive dynamics for curtailing the RBOCs', in this instance, Verizon's, market power. Further, the upward movement in end user/retail prices is made possible by the high degree of concentration in telecommunications markets and the fact that intermodal competition is not predominantly price-oriented competition.<sup>37</sup>

Of course, as the CLECs increase their retail rates, Verizon could respond by keeping its retail rates constant in order to expand its market share at the expense of the CLECs. However, there are a number of reasons why Verizon will opt to increase its retail rates in tandem with other market participants. We have already discussed the GAO Report finding that pricing flexibility for local network facilities translates into higher rates. Further, as will be discussed below, in highly concentrated markets such as telecommunications markets, dominant firms generally are able to increase their profits by raising prices and forfeiting larger market shares.

### **C. Granting Verizon Forbearance from TELRIC-Based Pricing of UNEs Would Create a Qualitative Change in the Nature of the Retail Market**

Even more important than a simple increase in the wholesale cost of CLECs is the qualitative change in the retail market structure that would occur if Verizon is relieved of the TELRIC pricing obligation for loop and transport network elements. In the current marketplace, CLECs provide a disciplining force to retail prices. Even though CLECs' actual market share may not be large, *the potential for CLEC entry*<sup>38</sup> through purchase of

<sup>37</sup> This is evident from the existence of different price levels offered by competing providers. See, for example, Verizon Virginia Beach Petition, Lew/Wimsatt/Garzillo Declaration, Exhibit 1 comparing competitive calling bundles: Verizon Freedom Essentials Plans (local and unlimited long-distance with 3 features at \$46.99) is \$12 more expensive than a similar plan (but with 10 features) offered by CLEC Cavalier, and \$7 more expensive than Cox's offering (which includes 6 features). Similarly, Exhibit A to Cavalier Telephone, LLC's Opposition To Verizon's Petition For Forbearance in docket WC No. 08-49 dated May 13, 2008 ("Cavalier Opposition") shows even more sizable price differences in voice/Broadband and voice/Broadband/video offerings of these three companies, with price differences observed not only in the "base" bundle offerings, but also in prices of the accompanying equipment such as an Internet cable modem. The same document shows that in all three product buckets (voice only; voice/Internet and voice/Internet/video) the CLEC (Cavalier) offers the lowest price.

<sup>38</sup> Note that in the Virginia case that deregulated Verizon local exchange service in many exchanges, the Virginia Commission noted that "Verizon has repeatedly argued that in those areas of Virginia, the threat from "uncommitted entrants," *i.e.*, other providers who do not presently offer local telephone service but theoretically could decide to offer telephone service some day if Verizon raised prices high enough, would restrain Verizon's price increases." (Virginia State Corporation Commission Case No. PUC-2007-00008, *Application of Verizon Virginia Inc. and Verizon South Inc. for a Determination that Retail*

TELRIC-based UNEs creates downward pressure on retail telecommunications prices because a new entrant may obtain bottleneck network elements at economic cost, and is thus capable of pricing retail services at economic cost. This situation is similar to the economic concept of contestable markets in which the presence of potential competition (not necessarily actual competition) constrains prices of a single producer and results in market prices similar to those of a competitive market. If the requirement of TELRIC-based pricing for network elements is eliminated, the retail markets would not be constrained by the threat of quick competitive entry. If Verizon's Petitions are granted, Verizon would have the means (*i.e.*, essential facilities) and the opportunity (*i.e.*, elimination of competitors who obtain network elements at economic cost) to dominate the retail stage of the wireline market, with the surviving CLECs acting as a competitive fringe that follows the price leader, the dominant firm. Even assuming the presence of another facilities-based provider (*i.e.*, a cable company) in certain market segments, the resulting retail market structure would be an oligopoly, in which few dominant suppliers extract above-normal profits through their ability to charge prices that are higher than prices in a competitive market.

#### **D. Firms with Market Power – Such as Verizon – Are Willing and Able To Increase Profits by Raising *Retail* Prices and Forfeiting Larger Market Shares**

Basic economic theory suggests that Verizon has strong incentives to increase retail prices. A dominant firm, such as Verizon, does not generally seek to price its services so as to achieve – or maintain – a market share that is as large as possible. Rather, it will seek to raise prices to the greatest extent possible so as to maximize profits and it will do so even if this means forfeiting market share to competitors. In seeking to maximize its profits, a dominant firm, such as Verizon, will balance the gains in revenues (and profits) associated with higher prices against the loss of revenues (and profits) associated with a diminished demand and market share (caused by the higher prices). The incentives for Verizon's responses to CLECs' retail price increases are meaningfully captured by the Dominant Firm – Competitive Fringe Pricing Model.<sup>39</sup> Under this general pricing model, there exists some optimal and sustainable market share for Verizon depending on the magnitude of Verizon's cost advantages over its "fringe" competitors. The greater the cost advantage of Verizon over its fringe competitors, the larger the optimal market share that Verizon will be able to sustain at prices above competitive levels. To the extent that a grant of forbearance eliminates the requirement that network elements be priced at TELRIC, Verizon is given the discretion to select the desired level of cost advantage over its fringe competitors, the CLECs. The higher Verizon sets its wholesale prices, the

*Services are Competitive and Deregulating and Detariffing the Same* Order on Reconsideration, February 1, 2008 ("Virginia SCC Order on Reconsideration, Case No. PUC-2007-00008"), p. 14.)

<sup>39</sup> See Gaskins, Darius W., Jr., "Dynamic Limit Pricing: Optimal Pricing Under Threat of Entry." *Journal of Economic Theory* 3:306-22 (1971).

greater will be its cost advantage and the larger will be its optimal market share while charging retail prices above competitive levels.

Within the current context, the implications of the Dominant Firm – Competitive Fringe Pricing Model are that when CLECs are forced to increase their retail prices, Verizon should be expected to follow suit. To summarize, if Verizon’s Petitions are granted, Verizon would have the means, opportunity and incentive to increase retail market prices.

### **E. The Elimination of a Retail Competitors Will Facilitate Collusive Conditions and Lead to Higher Retail Rates**

Some of the CLECs, however, will not be able to increase their retail rates to levels necessary to sufficiently offset increases in Verizon’s wholesale prices. This may be particularly true for CLECs that are heavily dependent on Verizon’s facilities. Such CLECs will face greater cost pressures than CLECs that use more of their own network facilities (and who are in part – though only in part – insulated from the wholesale cost increases). Thus, some CLECs will be forced to scale back their operations or to exit an MSA if Verizon is granted forbearance in the majority of wire centers of this MSA.

In general, one or a few relatively small competitors can be an important factor in the nature and intensity of competition in the market. The effect of these retail competitors is often disproportionate to their size or market share. As explained above, as long as the CLECs are able to purchase network elements at TELRIC rates, they provide a disciplining force on retail markets. In addition, CLECs have been responsible for many innovations in telecommunications services.<sup>40</sup> A CLEC may focus on a specific end-user segment that may have been overlooked by a much larger incumbent such as Verizon. This behavior forces other firms to compete more aggressively and may undermine their ability to coordinate.<sup>41</sup> Thus, the disruptive behavior of the retail competitor, or maverick, favors consumers.

Verizon’s inevitable price squeeze, sanctioned by a grant of forbearance, would remove some CLECs and would significantly change the nature and intensity of retail competition. Higher retail prices would inevitably ensue as the elimination of the retail competitor, the CLEC, would diminish competition and enable the remaining

<sup>40</sup> See, e.g., *Opposition Of Earthlink, Inc. and New Edge Network, Inc.* WC Docket No. 06-172 (filed Mar. 5, 2007), at 3-11 and 13-14 (describing CLECs’ innovative offerings in broadband markets). One of the most relevant examples of CLECs innovations is Cavalier’s offering of triple-play (voice/Internet/video) products over existing copper loops in the Virginia Beach MSA by using MPEG 4 video compression technology. (“Cavalier Opposition,” pp. 4-5). This innovation allows Cavalier to offer video TV services to older and lower income neighborhoods – neighborhoods that would not be targeted by Verizon FTTP overbuilding plans.

<sup>41</sup> Baker, Jonathan B., “Mavericks, Mergers and Exclusion: Proving Coordinated Competitive Effects Under the Antitrust Laws,” 77 *New York University Law Review* (2002), at 135.

competitors, Verizon and the cable companies, to more easily engage in coordinated interaction – at the expense of consumers.

In short, the elimination of retail competitors, CLECs, from the market as a result of the requested forbearance would increase the degree of Verizon’s market power and, potentially, induce collusion, and is yet another reason to anticipate higher retail prices, as well as diminished consumer choice if forbearance is granted.<sup>42</sup>

### **1. The Elimination of CLECs Will Facilitate Coordinated Interaction Between Duopolists**

The elimination of CLECs as a disciplining force for retail prices would lead to a reduced number of competing entities in the market, which would facilitate tacit coordination or collusion between the shrinking numbers of remaining service providers.<sup>43</sup> The retail competitors (*i.e.*, CLECs) have been thwarting the ability of the intermodal competitors, predominantly Verizon and the cable companies, to reach consensus. That is, there may have been no coordination heretofore because of the retail competitor-led impediments to such coordination such as (1) differences in incentives to reach consensus due to the practices of retail competitors or maverick practices; (2) complexity and/or lack of transparency in market outcomes to make consensus or detection feasible; or (3) lack of credible punishment strategies.<sup>44</sup>

The focus of the consequences of removing the retail competitor (*i.e.*, the CLECs) is not so much on the joint maximization of profit, but rather that of policing a collusive agreement.<sup>45</sup> As pointed out by modern game theory, in the presence of the particular

<sup>42</sup> The expectation that fewer market participants or weaker competition will increase retail rates is documented in numerous empirical studies. For example, the recent FCC “Report on Cable Industry Prices” (released on January 16, 2009 in docket MM No. 92-266) contains a statistical study of nationwide data on cable prices that quantifies the relationship between an increase in market concentration and cable prices. Using the results of this study (Appendix B, ¶¶ 15-20 to the Report, price elasticity estimate to market concentration (coefficient on variable HHI)), we calculated that a change in the market structure from a market of three firms of equal size (33% market share) to a market of two firms of equal size (50% market share), the retail prices would increase by 5.5%. Several empirical academic studies addressed the increase in retail prices due to mergers in mobile telephony industry and estimated that a merger leading to duopoly would cause a 6-10% increase in retail prices. (*See* Busse, M. (2000) Multimarket Contact and Price Coordination in the Cellular Telephone Industry, *Journal of Economics & Management Strategy*, vol. 9, pp. 287-320. and Grzybowski, L., and Pereira, P. (2007) Merger Simulation in Mobile Telephony in Portugal, *Review of Industrial Organization*, Vol. 31, pp. 205-220.)

<sup>43</sup> More formally, coordinated interaction consists of actions by a group of firms that are profitable for each of them as a result of the accommodating reactions of the other. This behavior may consist of tacit or express collusion. The seminal article is George Stigler, “A Theory of Oligopoly” 72 *Journal of Political Economy* (1964).

<sup>44</sup> Philips, Louis, “Oligopoly and Collusion,” *The Economics of Imperfect Information* (1988).

<sup>45</sup> Roberts, K., “Cartel Behavior and Adverse Selection,” 33 *Journal of Industrial Economics* (1983), at 401-413.

factors governing the feasibility of collusion, through repeated interaction the two companies may reach an equilibrium where prices are higher and output is lower.<sup>46</sup>

Thus, absent the presence of retail competitors, possible coordination between duopolists becomes far more likely. (Possible methods of coordination may include coordinating on price or capacity or allocating customers.) Without competitors in the retail environment, prices are transparent, rendering price coordination much more feasible. Customer allocation also is feasible because there is consistency in the customer base and because each duopolist can easily identify providers of customers who left the duopolist, and the reasons for changes can be readily ascertained.

In the current instance, this means that as long as CLECs have access to cost-based wholesale facilities, they will always be able to defeat any attempts at collusion between Verizon and the cable companies. Of course, after a grant of forbearance, Verizon would be able to increase its wholesale rates and diminish or eliminate the CLECs' ability to disrupt collusion. It is important to re-iterate that while a de-facto duopoly (or oligopoly) may be observed today in certain telecommunications markets, the availability of UNEs at cost-based prices create a disciplining factor that constrains oligopolists from exhibiting their market power: If the oligopolists increase their retail prices significantly, a new CLEC competitor would enter the market. However, if Verizon's Petitions are granted, this disciplining force would be eliminated.<sup>47</sup>

## **2. Intermodal Competition is Not Price Constrained Competition**

The intermodal competition between the two dominant service delivery platforms, wireline and cable, is not played out primarily by means of price competition. Rather, the dynamics between the platforms is far more complex, with each having unique functionalities, strengths, and weaknesses, which are not or are only partially shared by the other. First, there is typically only one cable operator in the area, meaning that the rivalry between the incumbent telephone company (Verizon) and the cable company is best described as "oligopoly" or "duopoly" rather than price-based competition.

Second, the success of cable companies in residential telephony markets is largely based on their bundling strategy with cable TV and broadband Internet products (meaning that product differentiation, rather than price competition is the business model for such multi-product market). As pointed out by some commenters,<sup>48</sup> cable's ability to acquire a significant share of the residential telephony market is based on their legacy position as a provider of cable TV, the economies derived from such bundled offerings (the

<sup>46</sup> Church, Jeffrey & Roger Ware, *Industrial Organization: A Strategic Approach* (2000), at Chapter 10; Jean Tirole, *The Theory of Industrial Organization* (1992), at Chapter 6.

<sup>47</sup> More specifically, this disciplining force would be significantly weakened because the retail price increase would have to be substantial before a new entrant would find it profitable to enter the market.

<sup>48</sup> One Communications et al. April 14, 2009 Ex Parte in WC Docket No. 08-49 p. 4.

economies of joint production when offering cable TV, broadband Internet and cable telephony over the same network) and the fact that cable's entry into telephone markets took place at the time when cable companies enjoyed significant dominance in cable TV markets (i.e., before the telephone companies' entrance into video markets). These advantages are not present in business telephony markets.<sup>49</sup> In other words, even if a cable network footprint extends beyond residential areas (the market base of its traditional business, cable TV), the cable company would likely achieve a much smaller success in business markets compared to residential markets.

In sum, given the highly concentrated and increasingly duopolistic nature of telecommunications markets, it is highly unlikely that the cable companies will have an interest in meaningfully curtailing Verizon's ability to raise retail rates in the two MSAs at issue. More likely, cable companies will welcome the additional breathing space created by Verizon's higher retail rates and continue to encounter Verizon in the marketplace based on factors other than price.

#### **IV. DESCRIPTION OF *QSI IMPACT STUDY* METHODOLOGY**

In the above Sections we have demonstrated that forbearance would first lead to increases in wholesale rates and then to increases in retail rates in the six MSAs at issue. The *QSI Study* quantifies the costs of forbearance by identifying the total increases in retail telecommunications expenditures in the two MSAs.

##### **A. Study Methodology and Data**

The expected estimated impact is driven mainly by Verizon's request for forbearance from loop and transport unbundling obligations and the price increases for loop and transport facilities that would occur if Verizon was no longer required to provide those facilities at TELRIC rates in the two MSAs at issue.<sup>50</sup> The use of current special access

<sup>49</sup> As explained in *One Communications et al.* April 14, 2009 Ex Parte in WC Docket No. 08-49, p. 13, while residential marketing strategies are based on standardized product offerings and bundles, customer acquisition in business markets involves very different marketing strategies, involving personalized customer service, customized product offerings, face-to-face meetings and site visits with prospective clients.

<sup>50</sup> As pointed out in a July 10, 2007 ex parte letter in WC Docket No. 06-172, "[w]hile Verizon suggests that it would have the incentive to offer commercially reasonable rates and terms, the truth is that Verizon has no such incentive in the absence of its § 251(c)(3) obligations. Even if Verizon chose to offer a post-forbearance contractual replacement for UNE loops, it is unlikely that the terms of such an offering would be comparable to the rates that could be expected to exist in a truly competitive market." This Ex Parte goes on to state that Verizon's commercial pricing "will be no lower than the recurring and nonrecurring charges Verizon originally proposed to charge for copper loop UNEs in rate proceedings before various state commissions." See a July 10, 2007 ex parte letter in WC Docket No. 06-172 filed on behalf of Alpheus Communications, L.P.; ATX Communications, Inc.; Cavalier Telephone Corporation; CloseCall America, Inc.; DSLnet Communications, LLC; Eureka Telecom, Inc. d/b/a InfoHighway

rates as a proxy for the rates that would result is a very conservative approach because special access rates are likely to increase absent the discipline provided by the availability of UNEs.<sup>51</sup> Also, as pointed out by Telecom Investors,<sup>52</sup> CLECs have an additional special concern regarding copper loops: Because special access is a service, rather than a facility (as opposed to unbundled loops), formally, “voice grade” special access tariffs offering may not be a suitable substitute for “copper loops.” As mentioned above, CLECs offer various advanced services over “copper loops,” including IP TV and Ethernet (by attaching electronics that expands the bandwidth of copper loops), and the special access “voice grade” service is not a suitable analog to the required copper loop facility. In other words, our assumption that if forbearance is granted, Verizon would continue to offer copper loop facilities (but at a special access rate) is also a conservative assumption.

Using publically-available demand data, the *QSI Study* focused on the impact of a grant of forbearance in the following four markets:<sup>53</sup>

1. Mass market voice (measured by residential and small business switched access lines);
2. Enterprise market (measured by multi-line business switched access lines);
3. High-speed broadband Internet market; and
4. Residential video market (measured by households subscribing to cable TV service).<sup>54</sup>

Communications; ITC^DeltaCom Communications, Inc.; McLeodUSA Telecommunications Services, Inc.; MegaPath, Inc; Mpower Communications Corp.; Norlight Telecommunications, Inc.; Penn Telecom, Inc.; RCN Telecom Services, Inc.; RNK Inc.; segTEL, Inc.; Talk America Holdings, Inc.; TDS Metrocom, LLC; and U.S. Telepacific Corp. d/b/a Telepacific Communications. This assumption is overly conservative because Verizon’s proposals in a contested UNE rate proceedings (to be reviewed under the TELRIC standards) is likely to be lower than Verizon’s proposal in commercial negotiations regarding its essential bottleneck facilities – commercial negotiations in which Verizon clearly has negotiating advantage and in which there are no prescribed pricing standards, no burden of proof, and no regulatory oversight.

<sup>51</sup> This point was extensively covered in dockets associated with Verizon’s 2006 Six-MSA Petitions: *see, e.g., ACN, et al. Opposition*, at 39; *Comments of Time Warner Cable*, WC Docket No. 06-172 (filed Mar. 5, 2007), at 21; *Reply Comments of Paetec Communications, Inc. and US LEC Corp.*, WC Docket No. 06-172 (filed Apr. 18, 2007), at 4; and *Telecom Investors Opposition*, WC Docket No. 06-172 (filed Mar. 5, 2007), at 4. Time Warner Cable explained that the presence of UNEs in the marketplace disciplines the incumbent LEC’s special access pricing. *See Time Warner Cable Comments*, at 21. It bears noting that in all both MSAs, Verizon has full pricing flexibility for special access transport, and in the Virginia Beach MSA, Verizon has full pricing flexibility for local channel terminations. It also bears noting that the Verizon-MCI merger condition that prohibits the company from increasing its special access rates expired in July 2008. *See ACN et al. Opposition* at 38.

<sup>52</sup> Telecom Investors’ Opposition, Docket No. WC 08-49, p. 17.

<sup>53</sup> The market definitions used in this study follow the FCC’s, as adopted in the *Qwest Omaha Forbearance Order*, at ¶¶ 21-22.

<sup>54</sup> QSI derived the volume information for these markets by pooling various data sources, including the ILEC and CLEC line count data from the FCC’s most recent Local Competition Report, ARMIS 43-08 Reports, the FCC Report High-Speed Services for Internet Access, the FCC most recent Annual Report on video competition, publicly-available wire center line count data from the FCC’s high-cost fund support calculations, MSA-level population and household counts from the Census Bureau, county-level population

QSI added the fourth market – residential video market (which was not analyzed in QSI’s 2007 Study) because the continuing convergence between residential video, voice and broadband Internet markets became even more apparent in the last two years. Not only do cable companies offer telephony and Internet services, but both incumbent and competitive local exchange carriers are entering video markets. As stated in Verizon’s 2008 Annual Report, “[w]ith FiOS, we are redefining the consumer telecom business as a broadband and video business.... With FiOS, we have created the opportunity to increase revenue per customer as well as improve retention and profitability as the traditional fixed-line telephone business continues to decline as customers migrate to wireless, cable and other newer technologies”<sup>55</sup> As mentioned above, CLECs such as Cavalier in Virginia are now offering video services over copper loops.

QSI collected Verizon’s current UNE and special access recurring rates for key network elements, *i.e.*, local loops and transport. QSI then calculated the difference between UNE-based and special-access based rates for various network element combinations under which end-user markets in the study are typically served. The charts depicting the difference between Verizon’s recurring UNE and special access rates by Petition area are presented in Section II(c) above.<sup>56</sup>

The calculated difference between UNE and special access rates constitutes the increase in wholesale cost faced by CLECs if forbearance is granted – the increase that CLECs may partially absorb (thus decreasing their margins and causing them potentially to exit the market) or/and partially pass through to retail customers (thus weakening the retail price discipline that UNE-based CLECs provide to retail markets)<sup>57</sup> The end result is that the overall level of retail prices will go up following the increase in CLECs’ wholesale costs.<sup>58</sup> The *QSI Study* reasonably assumes that the price increases in retail

and personal income data from the Regional Economic Information System of the Bureau of Economic Analysis, and cable penetration data from the National Cable and Telecommunications Association.

<sup>55</sup> Verizon Communications, Inc. 2008 Annual Report, p. 3. The Report goes on to explain that Verizon’s FTTH fiber networks, “FiOS delivers ultra-fast Internet speeds and more high-definition video channels than any cable provider in the market today. These features have helped us achieve 25 percent market share for FiOS Internet and 21 percent for FiOS TV in four short years.”

<sup>56</sup> When utilizing the calculated differences described above in its impact calculations, QSI accounted for the fact that Verizon is not required to provide unbundled access to high capacity loop and transport UNEs in certain wire centers due to the FCC’s *TRRO*. QSI also excluded wire centers in which Verizon is not asking for forbearance.

<sup>57</sup> For further discussion of the price discipline provided by CLECs, *See Opposition of Cavalier Telephone Subsidiaries*, WC Docket No. 06-172 (filed Mar. 5, 2007), at 12-13.

<sup>58</sup> The specific channels through which the overall market price increase would occur may include an increase in rates for non-regulated or de-regulated services. In Virginia, the State Corporation Commission deregulated Verizon’s local exchange services in many exchanges at the end of 2007, noting that “we granted Verizon deregulation of approximately more than 62% of all residential lines and 57% of business lines, plus statewide deregulation of bundled and some other services.” (“Virginia SCC Order on Reconsideration, Case No. PUC-2007-00008”, p. 14.) Cable company telephone rates are not price regulated, and even Verizon has flexibility to increase many of its rates. For example, Verizon Rhode Island Petition included a comparison of Cox and Verizon prices available on Cox’s web site ([www.cox.com/newengland/telephone/pricing\\_ri.asp](http://www.cox.com/newengland/telephone/pricing_ri.asp)) as Exhibit 3 to Lew/Wimsatt/Garzillo Declaration.

markets will be smaller than the price increases in the wholesale market, and will be accompanied by decreases in demand. For video services the *QSI Study* utilizes the above discussed FCC's estimates of cable price elasticity to market concentration<sup>59</sup> to calculate the increase in retail video prices stemming from the elimination of CLECs in video competition.<sup>60</sup>

## B. Results of *QSI Study*

QSI calculated the impact of granting Verizon's Petitions as an increase in retail telecommunications expenditures associated with mass market voice, enterprise and high speed broadband Internet markets.<sup>61</sup> This impact estimate is **\$210 million annually for the two MSAs at issue**. The charts below provide a breakdown of this estimate by market segment and affected MSA.

A review of the same Cox web site a year later (in March 2009) reveals that many of the rates listed in this exhibit – both Cox's and Verizon's – have increased. For example, Cox's Digital Phone Primary Line service increased by \$1.55/month; Call Waiting and Voice Mail services increased by \$1 each; Caller ID increased by \$0.5; Service Assurance (inside wire maintenance) increased by \$1/month; Out-of-State Long-Distance usage rate increased by \$0.03/minute. Similarly, based on the same comparison of Exhibit 3 with the current version of Cox's web site, Verizon's monthly rates for Call Forwarding, Call Return, Caller ID, Call Waiting increased by \$0.50 each, and Voice Mail increased by \$1. It is also worth noting that while Cox's Virginia current prices also increased compared to the price sheet included in Verizon's Virginia Beach Petition (Exhibit 3 to Lew/Wimsatt/Garzillo Declaration, which we compare to the current version of the same pricing sheet available at [www.cox.com/hr/telephone/packages.asp](http://www.cox.com/hr/telephone/packages.asp)), Cox's price increases in Virginia are smaller than its price increases in Rhode Island in both absolute and relative terms. Specifically, in Virginia Cox's basic phone service rate increased by \$0.16 (from \$15.39 to \$15.55), and rates for calling features stayed constant. By way of a numerical example, Cox's basic local line with call waiting and caller ID increased by a total of \$0.16 / month in Virginia, and by \$3.05 /month in Rhode Island. While we do not know exactly what caused this difference in Cox's rate changes, one potential explanation would be that Virginia residential markets are more competitive with Cavalier offering triple-play products. As noted by NASUCA, granting Verizon's Petitions may allow Verizon to increase its Federal Subscriber Line Charge. *Comments of the National Association of State Utility Consumer Advocates, the Pennsylvania Office of Consumer Advocate, the Public Utility Law Project of New York, Inc., the Massachusetts Office of Attorney General, the Virginia Office of Attorney General, the Maryland Office of People's Counsel, the New Jersey Division of Rate Counsel, the New Hampshire Office of Consumer Advocate and the Connecticut Office of Consumer Counsel*, WC Docket No. 06-172 (filed Mar. 5, 2007), at 23. NASUCA noted further that “[e]ven in the presence of regulations, Verizon has shown a tendency toward rate **increases**, rather than rate decreases, to respond to ‘competition’ in the market for its bundled services,” pointing to Verizon's recent tariff transmittal to increase rates for bundles in Maryland, Massachusetts, New Jersey and Pennsylvania. *Id.*

<sup>59</sup> The FCC “Report on Cable Industry Prices” (released on January 16, 2009 in docket MM No. 92-266), Appendix B, ¶¶ 15-20.

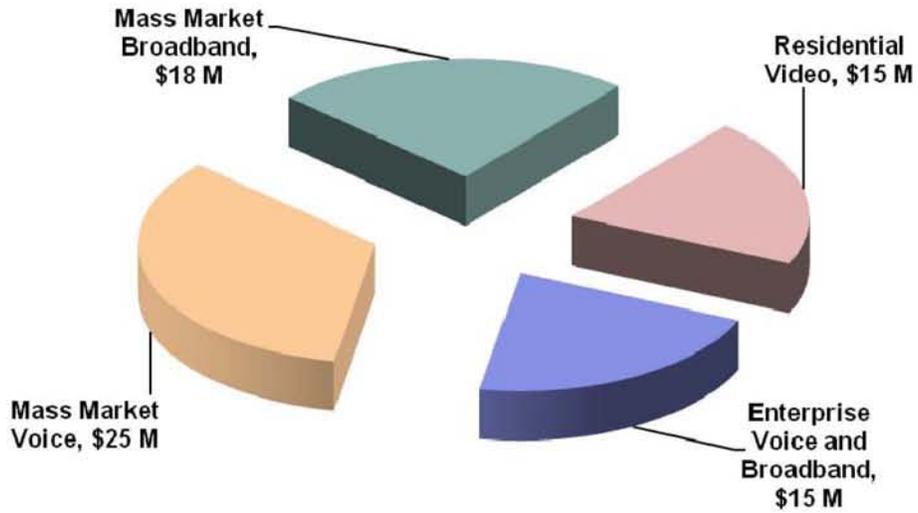
<sup>60</sup> While it may be argued that presently the CLEC competition in video markets is substantial only in the Virginia Beach MSA (and not in Rhode Island), we stress that the pressure of potential competition (as well as the potential for actual entry in the near future) is equally important when evaluating Verizon's Petitions.

<sup>61</sup> As noted above, the *QSI Study* reasonably assumes that retail demand volumes would go down in response to market price increases. This reduction in market demand causes a societal welfare loss known in economics as a *deadweight loss* to society. QSI's estimated impact did not include this effect.

**INCREASE IN ANNUAL END USER EXPENDITURE BY MARKET**

*Rhode Island Petition*

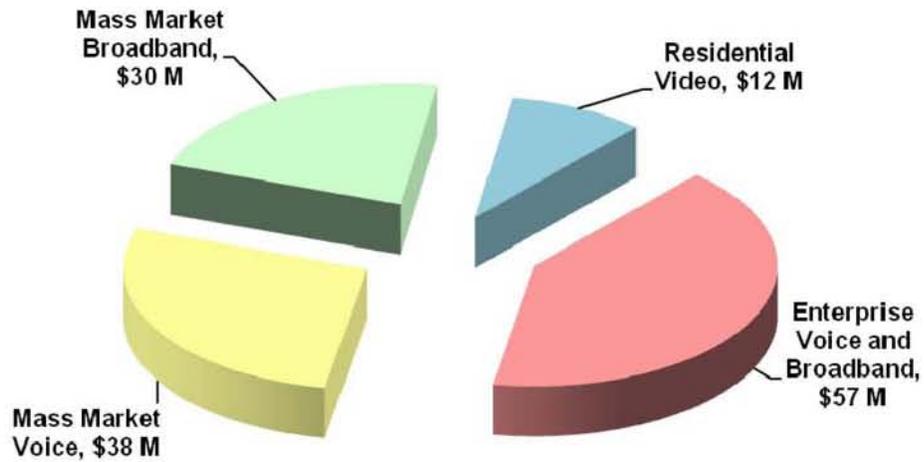
**Total Increase: \$ 73 Million**



**INCREASE IN ANNUAL END USER EXPENDITURE BY MARKET**

*Virginia Beach Petition*

**Total Increase: \$ 138 Million**



The following table places this estimate in context by comparing the projected increase in residential household expenditures to the current residential household wireline expenditures.<sup>62</sup>

**Increase in Total Annual Residential Retail Expenditures per Household**

<b>MSA</b>	<b>Total Residential Increase Per Household</b>
Providence	\$54
Virginia Beach	\$77
<b>TOTAL 2 MSAs</b>	<b>\$66</b>

Finally, the following table provides an additional context for the total impact across all markets. It lists the total impact in the business segment as a percentage of total wireline business end user revenue in each affected MSA.

**Increase in Total Annual Business Retail Expenditures**

<b>MSA</b>	<b>Total Business Increase as % Total Business Retail Wireline Revenues</b>
Providence	9%
Virginia Beach	19%
<b>TOTAL 2 MSAs</b>	<b>14%</b>

<sup>62</sup> Current household wireline expenditures are based on the 2006 data from the FCC’s “Reference Book of Rates, Telephone Indices, and Household Expenditures for Telephone Services” (2008), Tab 2.6 and Bureau of Labor Statistics 2006 Consumer Expenditure Survey.



## **V. CONCLUSION**

Based on our analysis, we estimate that Verizon's Petitions – if granted – would result in a \$210 million increase in retail telecommunications expenditures in the Providence and Virginia Beach MSAs annually, including a \$66 annual increase in residential household bills. This increase would result from the qualitative change in retail telecommunications markets in these MSAs, where the pricing discipline provided by CLECs who currently obtain network elements at TELRIC rates would be diminished or eliminated.