

**COMMONWEALTH OF PENNSYLVANIA
SENATE COMMUNICATIONS AND HIGH TECHNOLOGY COMMITTEE**

Hearing on
Chapter 30 and the Telecommunications Industry
in Pennsylvania

Testimony of

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TESTIMONY OF DR. LEE L. SELWYN

Introduction

Good morning Chairman Corman and members of the Committee. My name is Lee Selwyn. Thank you for giving me the opportunity to appear here today to share my thoughts on the current state and future of Pennsylvania's telecommunications industry and network resources following enactment of Chapter 30. Specifically, I have been asked by AT&T to provide you with an overview of Verizon's compliance — or, more accurately, its *noncompliance* — with the Chapter 30 “deal” that its predecessor, Bell Atlantic-Pennsylvania, had made with the Pennsylvania legislature and the Pennsylvania Public Utility Commission (“PUC”).

In enacting Chapter 30 in 1993, the Pennsylvania legislature embarked upon a bold plan that would lead to the construction of a 21st century telecommunications infrastructure throughout all parts of the Commonwealth — urban, suburban and rural. In choosing this particular course of action, however, the legislature was implicitly accepting, *on faith*, several key premises:

- (1) That competitive marketplace forces could not by themselves be expected to attract the necessary investment capital to assure *universal* deployment and *universal* availability of state-of-the-art mass-market broadband telecommunications facilities;
- (2) That only the incumbent local exchange telephone utilities — principal among which was Bell Atlantic-Pennsylvania — had the technical and organizational resources needed to construct such facilities throughout all parts of the state; and

- (3) That the way to induce Bell Atlantic-Pennsylvania and the other incumbent telephone utilities to embark upon such an investment program was to revise the then-extant “regulatory bargain” by replacing the traditional “cost plus” or “Rate of Return” form of regulation with an “alternative regulation” regime in which prices would be de-linked from costs and in certain cases would be deregulated altogether, and where traditional limits on the utilities’ earnings would be eliminated.

Shortly after Chapter 30 became law, Bell Atlantic-Pennsylvania asked the PUC to adopt a Chapter 30 alternative regulation plan in exchange for Bell’s commitment to deploy a broadband infrastructure throughout its service areas. While completion of the full statewide build-out would not be accomplished until 2015, Bell’s plan called for specific milestones and, in particular, a commitment to reach the 20% mark in the urban, suburban and rural areas of the state by the end of 1998. Concerned that Bell may not have been living up to its deployment commitments, AT&T and MCI asked my firm to undertake a study of Bell Atlantic-Pennsylvania’s performance under Chapter 30 both with respect both to its progress in deploying broadband facilities as well as the specific financial gains that the utility had realized as a result of the “alternative regulation” plan. What we found was a serious lack of network modernization, coupled with a substantial increase in Bell earnings. The following year, we took a second look at the deployment of broadband services in the Commonwealth. By that time, several cable television systems had begun offering their customers high-speed access to the Internet over their cable TV systems, and Bell Atlantic had begun to respond with a competing service known as Asymmetric Digital Subscriber Line (“ADSL”). It is particularly noteworthy that it was the immediate threat of real competition from cable — and not any “commit-

ments” that Bell Atlantic had made in exchange for Chapter 30 regulation — that finally pushed the phone company into offering a pseudo-broadband service.

The basic premises of the Chapter 30 approach were seriously flawed

Unfortunately, experience over the eight years since the Bell Chapter 30 plan become operational has shown that all three of the *on faith* premises underlying the legislation were seriously flawed:

- Notwithstanding any “commitments” or “regulatory bargains,” it is marketplace conditions that will ultimately drive the incumbent telephone utilities’ investments. Indeed, Verizon-Pennsylvania has readily admitted that its broadband investments are being entirely driven by “competition, not government regulation.”¹ Verizon-Pennsylvania’s sister utility, Verizon North, in its own Chapter 30 filings with the PUC, had actually included specific “escape clauses” under which it would not be required to proceed with broadband deployment if demand for these services failed to materialize.²
- The incumbent local telephone utilities are no longer (if they ever were) the only entities capable of building out a statewide broadband infrastructure. Passage

1. Testimony of Frank P. Buzydlowski and Debra M. Berry before the House Consumer Affairs Committee, Pennsylvania House of Representatives, presented August 15, 2002, at p. 2.

2. Verizon North (and its predecessor GTE North) petitioned the PUC twice for Chapter 30 regulation. Each of these petitions conditioned broadband deployment upon specific demand thresholds. See *Petition For Alternative Regulation and Network Modernization Plan of GTE North Incorporated*, Docket No. P-00981449, Proposed Network Modernization and Alternative Regulation Plan of GTE North Incorporated, December 15, 1998; *Petition of GTE North, Inc. For Alternative Regulation and Plan for Network Modernization*, Docket No. P-00981449, Prepared Direct Testimony of Michael E. Fay on Behalf of Verizon North Inc., filed October 31, 2000, at 6.

of the federal *Telecommunications Act* in 1996 put in place a structure whereby competing local service providers (“CLECs”) could enter the market through a combination of their own facilities and ones leased from the incumbent phone companies. Ironically, the various deregulatory measures and other financial benefits that Chapter 30 had conferred upon Pennsylvania’s incumbent phone companies have actually worked to *undermine* the competitive marketplace that had been envisioned by the federal legislation, making entry far more difficult and costly and thereby denying Pennsylvania the opportunity to fully benefit from a competitive telecommunications marketplace.

- Under Chapter 30, Verizon has amassed profit levels that had been unthinkable for “regulated” telephone monopolies. Verizon was also able to shift its yellow pages business out of regulation altogether, producing a windfall gain to its shareholders that is conservatively worth upwards of \$2.5-billion. While the Pennsylvania legislature may have expected that these earnings gains would have been used by the utility to finance its broadband deployment, very few of these excess profits have actually been returned to Pennsylvania. When Chapter 30 was passed, Bell Atlantic’s Pennsylvania operations represented some 29% of the corporation’s assets. Today, Verizon-Pennsylvania comprises only 3.9% of the much enlarged parent company’s portfolio, and the Pennsylvania company must now compete for capital dollars with Verizon telephone utilities in some 28 states and with other Verizon activities worldwide. It’s little wonder that Pennsylvania has gotten back far less than it has contributed to Verizon’s corporate wealth. Verizon recently disclosed that it has spent a half-billion dollars just to establish and develop the Verizon brand name³ — funds

3. Verizon Communications, Inc. 10-Q Report for the Quarterly Period Ended June 30, 2002, at Note 2.

that might otherwise have been spent building Pennsylvania's broadband infrastructure.

Verizon has made various claims as to its "compliance" with its Chapter 30 deployment commitments, but upon closer examination it becomes clear that these claims are linked to some rather creative revision and reinterpretation of exactly what those "commitments" had been at the time that they were agreed to.

- *What does "broadband" mean?* As enacted, Chapter 30 provides a specific, technical definition of "broadband" as "a communication channel using any technology and having a bandwidth equal to or greater than 1.544 megabits per second." 66 Pa C.S. Sec. 3002. Even by 1993 standards, that definition was highly conservative, particularly since Bell itself, in testimony supporting its own Chapter 30 petition, had described "broadband" as capacity in the 45 megabits per second range.⁴ What Verizon has done — and what it claims to be "compliant" with its Chapter 30 "commitments" — involves the offering of ADSL services on suitable subscriber lines, aimed primarily at the residential and small business market. ADSL provides what is frequently described as "high-speed" Internet access, but does not come even close to satisfying the statutory definition of "broadband" because it does not afford sustained transmission speeds of at least 1.544 megabits per second in both the upstream and

4. *The Bell Telephone Company of Pennsylvania's Petition and Plan for Alternative Form of Regulation Under Chapter 30*, Docket No. P-009350715, Alternative Regulation Plan dated October 1, 1993, at 25.

downstream direction.⁵ The PUC has soundly rejected Verizon's proffer of ADSL as meeting the Company's Chapter 30 obligations:

First, DSL, as Verizon PA currently provides it, is too slow to be considered a true broadband service as defined by Verizon PA in its original NMP. ... Second, DSL, as Verizon PA currently provides it, can only reach a speed of 1.5 Mbps, the slowest definition of broadband where the customer is located not further than 12,000 feet from the serving wire center. Only a limited number of Verizon PA's residential customers meet this criteria. ... Third, currently Verizon PA's ADSL can achieve 1.5 Mbps in only one direction, the downstream direction. In the upstream direction, it is limited to a maximum of 768 Kbps (0.768 Mbps).⁶

* * *

The Commission is concerned that Verizon PA has no statutorily mandated broadband service available now, or plans for it in the future, for residential customers.⁷

More importantly, ADSL is at best a *transition* technology that will likely become entirely obsolete long before the 2015 target date for completion of Verizon's Chapter 30 broadband commitment. As the transmission capacity of the Internet increases, as new video services and applications are introduced — including things like video telephony, video conferencing, distance learning, video-on-demand, telemedicine, and the still-elusive “killer applications” that will profoundly affect the infrastructure needs for decades to come — Verizon's existing ADSL-based services will be as obsolete as dial-up 56 kbps modems

5. Verizon does offer a version of ADSL with a nominal (although not guaranteed) *downlink* speed of 1.544 mbps and an uplink speed of only 768 kbps, at a monthly rate of \$59.95.

6. *Order Rejecting Verizon's 2000 NMP Update*, at 13.

7. *Id.*, at 16.

are today — and those were the “state of the art” as recently as only five or six years ago!

- *Rather than build to meet Pennsylvania’s future, Verizon has instead worked to downplay the Commonwealth’s needs.* Back in 1993, then-Bell Atlantic and its sister RBOCs were hell-bent on getting into the cable television business. And the cable TV infrastructure that Bell Atlantic was then envisioning — which would have involved 45 megabit capacity deployed to individual subscribers — would have easily “satisfied” the Chapter 30 definition of “broadband.” So the “promises” and “commitments” that Bell Atlantic was making to the PUC in exchange for “alternative regulation” were things that it had intended to do anyway and which had been driven by its then-current business plan. So from Bell Atlantic’s perspective, those “commitments” amounted to no more than what the Company was planning in any event — Chapter 30 or no Chapter 30. A few short years later, the Regional Bells’ interest in cable TV began to wane. US West spun-off its cable TV business (Media One), and SBC shut down the various cable ventures then underway by Pacific Bell, SNET and Ameritech almost as soon as the ink was dry on their respective mergers. Without cable TV, Verizon has no immediate plans to build out a mass-market 45 megabit distribution network, and isn’t even pursuing the far less ambitious 1.544 megabit capacity level. And what is Verizon doing to rationalize this about-face? As Verizon’s Debra Berry put it recently, “... it became obvious that giving customers 45 megabits per second would not be feasible and might even be a waste of bandwidth, or transmission capacity, since few users of the Internet can fully exploit 45-megabit speed.”⁸

8. Parker, Akweli, “A PUC member challenges Verizon’s fast-Internet rollout,” *The Philadelphia Inquirer*, March 29, 2002.

- *Verizon confuses the issue by diverting attention away from subscriber access facilities and over to interoffice facilities, which cannot by themselves provide “broadband” services to anybody. Verizon would have this Committee believe that high capacity in its interoffice network is sufficient to provide broadband services to end users. Verizon boasts that 100% of its interoffice facilities are provided over fiber, and as a result, “the current [Verizon] network has enormous capacity and is able to provide 45 Mbps, 155 Mbps, 622 Mbps, and expected gigabit broadband data services to a majority of customers today within a commercially reasonable time.”⁹ In fact, Verizon has claimed that “more than 50% of Verizon Pennsylvania lines already have access to Broadband services at speeds ranging from 1.5 to 622 mbps — nearly three years ahead of schedule.”¹⁰ However, by “have access to,” Verizon actually means that a customer can call the Company and order, for an extremely high price, high capacity broadband service on a “special service” basis. “Special services” are leased Private Line and Special Access services, which typically involve installation charges of several hundred to several thousand dollars and monthly recurring charges of a similar magnitude. Upon receiving an order from a customer, Verizon will then, apparently, make all the necessary changes to the distribution network (i.e. run fiber to the customer's home or business) to provide the service. Verizon may well be able to provide this type of service on demand to a limited number of customers at an exorbitant cost, but clearly the Committee should not consider these types of customized serving arrangements as providing “universally available broadband services.” Indeed, in rejecting*

9. *Petition for Reconsideration of Verizon Pennsylvania Inc.*, PUC Docket P-00930715, May 30, 2002, at 12.

10. Buzydlowski/Berry August 15, 2002, House Consumer Affairs Committee testimony, at 7, emphasis supplied.

Verizon's 2000 biennial filing earlier this year, the PUC was quite explicit that such services would *not* satisfy the broadband deployment requirements of Chapter 30:

We also believe that, under chapter 30, universal broadband availability excludes the notion of broadband services being offered at a level beyond the reasonable economic reach of the majority of a LEC's customers.¹¹

Broadband service that must be custom ordered, designed and implemented are both prohibitively expensive and limited in their application. Widening the Pennsylvania Turnpike to fifteen lanes in each direction — the analogy to Verizon's talk of increasing its *interoffice* capacity — does nothing to alleviate traffic jams in downtown Pittsburgh or in Center City Philadelphia, nor does it do anything to improve roads here in Centre County and in other rural parts of the state.

The Chapter 30 network build that was contemplated by the legislation was specifically *not* expected to be demand-driven

Nothing in Chapter 30 or in the "commitments" that the telephone utilities were required to make provided for a linkage between investment and customer demand. To the contrary, the interim and final (2015) target dates were designed to provide the state with a 21st century telecom infrastructure to meet demands and needs that were expected to exist in that time frame. In enacting Chapter 30, the legislature was specifically *not* relying upon *current* market demand to drive facilities

11. *Verizon Pennsylvania, Inc. Petition and Plan for Alternative Form of Regulation Under Chapter 30 2000 Biennial Update to Network Modernization Plan*, Pa. PUC Docket No. P-00930715, *Order*, May 15, 2002 ("*Order Rejecting Verizon's 2000 NMP Update*"), at 8.

investment and deployment; indeed, there would have been no need to “induce” Verizon to “respond” to demand that was already out there. And in fact both the legislature and the PUC recognized that there might well be no initial demand for broadband services. As the PUC noted in its order approving Bell Atlantic’s Chapter 30 Plan:

Bell’s deployment of broadband facilities will take place in locations where conventional economic, financial, business or plain engineering justifications for such deployment may not exist. In this respect, Bell may install broadband facilities and bear the associated variable and fixed costs of the investment without realizing any corresponding streams of revenues in return, especially if such broadband facilities are not going to initially serve significant demand quantities for telecommunications services. Thus, Bell may be called upon to bear the risk of such initially unproductive capital investments that will have to be installed under the Company’s modified Network Modernization Plan.¹²

This kind of forward thinking legislation of course anticipates that the utility will necessarily have to accept a certain amount of risk as well as a potentially protracted “ramp-up” period where the new facilities are in-place but are not yet fully in-use and producing revenue. It is this risk and start-up exposure that the legislature expected Bell Atlantic to accept and to absorb in exchange for the significant regulatory benefits that Chapter 30 was to provide. It is also this kind of risk and exposure that Verizon, having realized billions of dollars in earnings and other windfall gains, now seeks to escape.

12. *Bell Atlantic-Pennsylvania, Inc.’s Petition and Plan for Alternative Form of Regulation Under Chapter 30*, Docket No. P-00930715; P-00930715C001; P-00930715C002, Before the Pennsylvania Public Utilities Commission, *Opinion and Order*, June 28, 1994. at 1994 Pa. PUC LEXIS 142, *128.

Verizon has already attempted to limit its network investment to services for which there is *currently* a substantial market. Verizon North (formerly GTE North) applied for a Chapter 30 Plan in 1998, and proposed a network modernization plan that made future investment in its broadband network specifically contingent upon achieving a market penetration rate for broadband services of 5% following completion of each “step” of the NMP, and then only if it was able to achieve a relatively consistent level of revenues for its other regulated services that, under the 1998 Chapter 30 Plan, were to continue to be provided under ROR regulation.¹³ When Verizon North re-filed its Chapter 30 Plan in 2000, it also included a demand-based escape provision.¹⁴ Of course, since market penetration rates are directly related to the price that is ultimately charged for the service, Verizon North could easily avoid its NMP obligations simply by setting rates for the broadband services sufficiently high so as to ensure minimal market acceptance.

Verizon has reaped enormous and entirely unwarranted financial gains from Chapter 30 “alternative regulation”

Examining the trends in Verizon PA's total equity and net income makes it clear why Verizon PA is not interested in spearheading a broadband investment strategy prior to the arrival of demand. Verizon PA's return on equity is significantly higher than it would be under ROR regulation (nominally set at 15.15% ROE). Alternative regulation has proven a windfall for Verizon. Since the approval of Bell Atlantic PA's alternative form of regulation, the Company has consistently earned a return on equity of between 22% and 31%. Compared to the 15.15% ROE allowed under ROR regulation, Verizon has earned far beyond anything the legislature could

13. *Supra.*, at fn. 2.

14. *Id.*

possibly have anticipated — amounting to excess earnings of \$1.71-billion in real terms since 1994 (see the table below). In addition, during adoption of its Chapter 30 regulatory regime, Bell Atlantic-Pennsylvania asked the PUC to classify its yellow pages directory business as “competitive,” and shortly after receiving favorable PUC action on that request, Verizon *transferred this valuable business asset* out of the Pennsylvania company altogether and into a nonregulated Bell Atlantic affiliate operating entirely outside of the PUC’s jurisdiction.¹⁵ “Competitive” or not, unregulated Bell yellow page operations are a significant business asset. Qwest has just agreed to sell its entire 14-state yellow pages operation (“QwestDex”) for \$7-billion.¹⁶ Were Verizon’s Pennsylvania yellow pages business to be valued on a comparable basis (accounting for the relative size of the Pennsylvania market vs. the full 14-state QwestDex serving area), it would be worth approximately \$2.57-billion.¹⁷

Conclusion

Verizon Pennsylvania has realized financial gains in excess of \$4-billion as a direct result of Chapter 30 “alternative regulation.” Pennsylvania, however, is far from realizing a next generation broadband network. While this Committee will be

15. *Bell Atlantic- Pennsylvania, Inc.’s Petition and Plan For Alternative Form of Regulation Under Chapter 30*, Docket No. P-00930715, Public Utility Commission of Pennsylvania, *Opinion and Order*, June 28, 1994, at Ordering Paragraph 8; aff’d *Consumer Advocate v. Pennsylvania Public Utility Commission*, 1997 PA Lexis 2756. In 1997, Bell Atlantic PA announced that it had moved its directory publishing business to a separate affiliate. Bell Atlantic Corp. 10-K Annual Report for 1996.

16. “Qwest Has \$7B Sales Agreement For Directory Business,” *TR Daily*, August 20, 2002.

17. Verizon Pennsylvania operations are approximately equal to 36.6% of Qwest total operations. (ARMIS 43-08 Table III reports 2001 total switched access lines for Qwest at 17,069,619, and Verizon Pennsylvania at 6,255,932.) $36.6\% \times 7\text{-billion} = 2.57\text{-billion}$.

**Verizon (Bell Atlantic) - Pennsylvania
Return on Equity
(1994 - 2001)
In Thousands**

	(A)	(B)	(C)	(D)	(E)	(F)
Year	Net Income	Total Equity	Annual ROE (A/B)	ROE Earnings Allowance (15.15% x B)	Excess Over ROE Allowance (A - D)	Excess Earnings in Real Dollars (2002)
1994	\$362,100	\$1,384,800	26.15%	\$209,797	\$152,303	\$183,783
1995	426,100	1,383,900	30.79%	209,661	216,439	253,932
1996	417,100	1,344,300	31.03%	203,661	213,439	243,231
1997	351,300	1,198,600	29.31%	181,588	169,712	189,062
1998	407,600	1,342,000	30.37%	203,313	204,287	224,089
1999	482,300	1,606,100	30.03%	243,324	238,976	256,476
2000	495,900	1,810,300	27.39%	274,260	221,640	230,135
2001	422,300	1,918,300	22.01%	290,622	131,678	132,942
TOTALS	\$1,556,600	\$5,311,600		\$1,816,227	\$1,548,473	\$1,713,650

Sources: 10K Annual Reports of Bell Atlantic - Pennsylvania, Inc. and Verizon Pennsylvania Inc.

Net Income is exclusive of extraordinary items, 1994 also excludes Cumulative Effect of change in Accounting Principles- FAS 71; Inflation adjustment made using the Bureau of Labor and Statistics Inflation Calculator (Available at: <http://data.bls.gov/cgi-bin/cpicalc.pl>).

Adjustments:

2000 Net Income adjusted for "Other income (expense)" losses (and gains) from affiliates (e.g. investment in Verizon Advanced Data Incorporated) of \$31.1- million; 2001 Net Income Adjusted for "Other income (expense)" losses (and gains) from affiliates (e.g. investment in Ventures III) of \$186.9- million

examining possible courses of action in the next phase of these hearings, several preliminary observations can be made at this time:

- The pace at which telecommunications and information technologies are developing and changing argues against attempting to legislate a “preferred” technology or network architecture. It also argues strongly against entrusting such decisions to a single monopoly or dominant utility.
- Marketplace forces and competition provide the most efficient process for reacting and responding to changing technology and consumer demands. Yet one cannot and must not ignore the entrenched legacy telecom infrastructure that Verizon and the other incumbent phone companies have acquired largely if not entirely under protected monopoly franchises issued by the Commonwealth. The 1996 federal *Telecommunications Act* seeks to assure that new entrants can access these embedded network assets on a nondiscriminatory basis and at cost-based prices without confronting the impossible burden of having to duplicate the incumbents’ networks. The key to a competitive telecommunications future for Pennsylvania is for the PUC to vigorously and rigorously enforce the federal *Act* and FCC rules, including in particular the establishment of Unbundled Network Element (UNE) rates at Total Element Long Run Incremental Cost (“TELRIC”) as required by the FCC and as recently upheld by the United States Supreme Court. In that ruling, the Supreme Court also specifically rejected BOC arguments that because the TELRIC methodology resulted in low UNE rates, its use would deter BOC investment in the telecommunications network. Finding that the argument was contrary to both fact and law, the Supreme Court concluded that the facts support “the commonsense conclusion that so long as TELRIC brings about some competition, the incumbents will

continue to have incentives to invest and to improve their services to hold on to their existing customer base.”¹⁸ In an environment in which competing carriers will be encouraged to invest in Pennsylvania, Verizon itself will necessarily be forced to respond to that increased competition by expanding its own investment in Pennsylvania as well.

- While nominally “open” to competition, Pennsylvania’s local telecommunications market is still overwhelmingly dominated by Verizon and the other incumbents. By allowing these companies to divert valuable business assets to nonregulated affiliates and to amass billions of dollars in excess earnings, Chapter 30 has worked to enhance the phone monopolies’ market power and make it even more difficult for entrants to compete. While I do not necessarily advocate a return to pure Rate of Return Regulation, Pennsylvania’s consumers have clearly not benefitted from the enormous regulatory freedoms that Chapter 30 has conferred upon the state’s phone monopolies. Prices have become excessive and unreasonable, and the very fact that these high prices and high levels of earnings can be sustained for as long as they have been serves to underscore the utter lack of local telecommunications competition that has arisen in the Commonwealth up to now.

If I am invited to appear before you in the Phase III hearings, I will at that time offer specific recommendations for changes to the existing Chapter 30 structure that will, if pursued, work toward achieving the original goals of the 1993 legislation through an expanded reliance upon and support for effective and sustainable competition, reinforced by effective regulation that will protect the state’s consumers and

18. *Verizon Communications, Inc. et al v. Federal Communications Commission*, Nos. 00-511, 00-555, 00-587, 00-590 and 00-602, 535 U.S. _____, (May 13, 2002), *slip op.* at 46, fn. 33.

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minimize the potential for anticompetitive conduct by the incumbent telephone monopolies. I encourage you to work toward achieving this outcome.

Again, thank you for giving me this opportunity to meet with you this morning.