SUBSIDIZING THE BELL MONOPOLIES

How Government Corporate Welfare Programs are Undermining Telecommunications Competition

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Abstract

The regional Bells have remained largely insulated from the dwindling capital markets and shrinking economy by benefitting from numerous government programs and giveaways. These corporate welfare — Bellfare — programs work to support and to subsidize the RBOCs' ability to retain their entrenched market position and to make entry more costly and more difficult for would-be rivals.

Like pigs feeding at the trough, the RBOCs' appetite for government handouts and special regulatory privileges and concessions never seems to be satiated. They treat existing subsidies as entitlements, and they put forth new demands for special treatment to provide themselves with a "fair opportunity to compete" against largely nonexistent rivals or to "protect" themselves from competitive encroachments that they blame on the nation's competitive telecommunications policy.

Bellfare has conferred enormous financial value to these companies while diverting value and resources from entrants and from the economy generally. Bellfare rules and programs range from permissions to exploit preexisting incumbency advantages, the ability to impose exorbitant rates on wholesale and retail customers, to outright grants of free use of the public's property such as rights-of-way and electromagnetic spectrum.

As this study shows, these Bellfare benefits account for much of the current financial health — and wealth — of the RBOCs. Originally designed to ensure that the local telephone monopolies remained financially viable, the myriad of concessions fashioned over the last twenty years now work primarily to ensure that the RBOCs remain monopolies. This paper identifies and quantifies the "top ten" Bellfare programs, and puts their combined capitalized value at nearly $170-billion. This "bottoms-up" analysis is then corroborated by a "tops-down" calculation of the monopoly rents reflected in RBOC stock price premiums vis-à-vis book value. Because these regulatory "givings" have provided RBOC stockholders and management with massive and continuing financial transfusions from their customers and their rivals, it is little wonder that the RBOCs aren't feeling the pinch of the telecom market's current troubles.

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Introduction

Many explanations have been offered for the utter failure of meaningful competition to develop in the local telephone service market since enactment of the landmark *Telecommunications Act of 1996*. That legislation was intended — and expected — to "open the local service market" to competition and, in so doing, to constrain the market power of the incumbent local exchange telecommunications utilities ("ILECs") and, in particular, the regional Bell operating companies ("RBOCs").

Whatever its underlying cause, the inability of entrants to stake out a significant market position — or even to survive at all — is all too apparent. The value of competitive local exchange carrier ("CLEC") stock has been decimated,[1] and a number of once-promising initiatives have gone into bankruptcy.[2] The once-plentiful sources of capital needed to launch and sustain CLEC ventures — initially spurred on by the 1996 legislation and the promise of a competitive telecommunications future — has all but disappeared.

Yet while CLECs were imploding, the Bell companies have held their value relative to the market indices and have remained attractive to investors.[3] CLECs and the securities analysts who follow them have blamed the failure of local competition on the numerous obstacles that ILECs have placed in the way of the CLECs' ability to use, access and interconnect with the incumbent carriers' networks, notwithstanding the explicit obligations that are *imposed* upon ILECs by Sections 251 and 252 of the 1996 *Act*.[4] ILECs — and Bell operating companies in particular — have suggested instead that the failure of competition to materialize is simply the result of poor management or

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1. The most recent stock ratings for twelve of the largest CLECs downgraded eight companies. Overall market capitalization for 22 of the largest CLECs have declined by more than 70% since the third quarter of 1999. (Ratings taken from Yahoo! Finance (http://finance.yahoo.com/?u), March 1, 2002, and include the most recent ratings from a variety of respected analysts.)

2. "Global Crossing Topples into Bankruptcy, Agrees to be Acquired by Asian Partners," *TR Daily*, January 28, 2002; "McLeodUSA Bankruptcy: Bondholders get a sweater Deal, but Only 23% Commit," *TR Daily*, January 31, 2002; "Net2000 Files for Bankruptcy After Lenders Cut Off Funding," *TR Daily*, November 16, 2001; "Winstar Blames Lucent For Bankruptcy, Claims it was 'Seduced by Promises,'" *TR Daily*, April 18, 2001; "NorthPoint's Chapter 11 Filing Foresees 'Structured Sale' Of Assets," *TR Daily*, January 17, 2001.

3. The most recent RBOC stock ratings classify all but Verizon as a "Buy," with Verizon rated as "Attractive." In the period since the third quarter of 1999, RBOC market capitalizations have declined 33%, a rate that approximately mirrors the market's overall performance. (Ratings taken from Yahoo! Finance (http://finance.yahoo.com/?u), March, 1, 2002, and include the most recent ratings from a variety of respected analysts.)

4. 47 U.S.C. § 251(c) imposes a series of "duties" specifically upon *incumbent* local exchange carriers, including the specific "duty to negotiate in good faith in accordance with section 252 the particular terms and conditions of agreements to fulfill the duties described in paragraphs (1) through (5) of subsection (b) and this subsection." 47 U.S.C. § 251(c)(1). In the specific case of the BOCs, these "duties" are reinforced, at 47 U.S.C. § 271, with the "incentive" of in-region long distance entry as a reward for the otherwise *required* compliance with 47 U.S.C. §§ 251 and 252. In a series of rulings, the FCC has so substantially lowered the bar with respect to Section 271 that the BOCs have largely supplanted their efforts at actual compliance with a series of political initiatives. The BOCs thus have little or nothing to gain through "good faith" negotiations with their potential competitors, whose ultimate success could result in financial loss to the BOCs. Unlike most "normal" business transactions, BOC/CLEC negotiations do not produce a win-win result for both parties. It is thus both naive and unreasonable to expect the required "good faith" negotiations to actually materialize.

flawed business models on the part of CLECs.[5] That claim, of course, rings hollow in light of the inescapable fact that *virtually every CLEC that has attempted to enter the local service market has encountered these same ILEC-imposed roadblocks in every state jurisdiction.* This paper advances another explanation for the RBOCs' power and ability to crush their rivals — the pervasive and continuing flow of subsidies, grants of valuable public property, and a host of regulatory concessions by the government to the incumbents and incumbents only[6] — favors that collectively account for a substantial portion of the RBOCs' ability to maintain their local service monopoly and the resulting supracompetitive level of earnings, conditions that account for the substantial and sustained premium over book value of RBOC stock.

With the exception of Qwest (and for reasons largely unrelated to Qwest's RBOC activities),[7] the three largest RBOCs have remained insulated from the dwindling capital markets and shrinking economy by benefitting from numerous government programs and giveaways. To be sure, the RBOCs and other ILECs enjoy enormous advantages stemming directly from the basic scale economies and "first mover" advantages deriving from their *incumbency* positions in the local telecommunications market. But rather than seek to *neutralize* these incumbency benefits, US telecommunications policy has actually exacerbated and perpetuated them by conferring extraordinarily generous and enormously valuable largesse on these companies. These corporate welfare programs — *Bellfare* for short — work to support and to subsidize the RBOCs' ability to retain their entrenched market position and to make entry far more costly and more difficult for would-be rivals. Even if all of the "interconnection" issues[8] were to be instantly and totally resolved — and we are not even remotely close to attaining that goal — it may be simply too much to expect that competition can ever succeed in the wake of the persistence and expansion of the various *Bellfare* programs that are conferred upon and available only to the RBOCs and other ILECs.

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5. *See*, e.g., Reply Declaration of Dennis M. Bone, William E. Taylor, and Harold E. West, III on Behalf of Verizon New Jersey Inc., before the New Jersey Board of Public Utilities, Docket No. TO01090541, November 2, 2001, at para. 44.

6. While some of these subsidy programs are technically available to all LECs (such as above-cost access charges and uncompensated IXC-provision of calling number identification), the enormous differences in scale as between RBOCs and CLECs is so vast as to render inconsequential any actual benefit that CLECs might derive from such programs.

7. The former USWest, acquired by Qwest in 2000, has been besieged by management, service quality, investment, and legal problems. There are also indications that Qwest's current financial difficulties are a result of its long distance operations, and are not attributable to the USWest RBOC. In fact, a recent *Wall Street Journal* article quotes Bruce McDowell, a Qwest employee and union official, as stating, "Qwest has been milking the cash cow to keep them in the game... If Qwest didn't have USWest, they'd be in bankruptcy." The article also states, "[Qwest Chief Executive Joseph P. Nacchio] dismisses talk of bankruptcy and says he's 'not ashamed' that USWest is propping up Qwest, saying it's part of his 'long-term strategy.'" Deborah Soloman, "Bad Connection: How Qwest's Merger with a Baby Bell Left Both in Trouble," *Wall Street Journal*, April 2, 2002, at A1.

8. Interconnection (Sec. 251/252) issues yet to be resolved include unbundled network element (UNE) pricing, service ordering and provisioning procedures and installation internals, accurate and timely billing, mutual compensation for interchanged local traffic, and the scope of ILEC services and network functions that will be provided as UNEs, among others.

Corporate welfare flowing to the RBOCs accounts for a substantial portion of their overall profitability and market value, and provides a massive war chest to support pervasive cross-subsidization of those business segments where existing or potential competition is a factor.

The traditional regulatory model to which local telecommunications utilities had been subject contemplated a "regulatory compact" under which, in exchange for their government-protected monopoly status and the assurance of their ability to fully recover their investment, the utilities would agree to forgo the opportunity to gain monopoly profits and instead limit their earnings to what was described as the "competitive level" — that which a firm operating under competitive market conditions could expect to earn on its investment of similar risk and liquidity.[9] When competition was authorized and began to emerge, ILECs argued that this "regulatory compact" was no longer in place and that they should be permitted additional — and in some cases unlimited — earnings flexibility through one of several "incentive regulation" arrangements. At the same time, and clearly desirous of the ability to "have their cake and eat it, too," the ILECs have maintained that competition and "incentive regulation" notwithstanding, they are still entitled to "be made whole" with respect to their "embedded" investment.[10] Significantly, in advancing these various "make whole" claims, the RBOCs have never given any recognition to the numerous *Bellfare* handouts as in any way offsetting or mitigating the alleged "economic losses" they have sought to ascribe to competitive entry.

In its 1996 *Access Charge Reform NPRM,*[11] the FCC suggested that it might be appropriate to force ILECs to choose between having their cake and eating it, too, by making them elect either to be made whole with respect to their embedded investment, or to forgo that opportunity in exchange for the right to exploit their existing asset base without any limit on their earnings:

> In the event we adopt one of the special regulatory mechanisms described above or an alternative mechanism advocated by parties in this proceeding, as part of a transition to a competitive environment, we seek comment on whether some limitation on incumbent LECs' earnings is warranted. For example, we invite parties to comment on whether, if we set up a special mechanism that permitted incumbent LECs a reasonable opportunity to recover certain costs, it would be appropriate to limit to a certain prescribed rate of

9. James C. Bonbright et. al., *Principles of Public Utility Rates*, Public Utility Reports, Inc., 1988, pp. 198-201.

10. 47 U.S.C. 252(d)(1) requires that "the just and reasonable rate for the interconnection of [ILEC] facilities and equipment ... and ... for network elements ... shall be based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable)." The FCC has determined that "cost" for this purpose shall be Total Element Long Run Incremental Cost ("TELRIC"). *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* CC Docket No. 96-98, First Report and Order, released August 8, 1996, 11 FCC Rcd 15499 ("*First Interconnection Order*"), at para. 29. ILECs have argued that setting interconnection and UNE prices below their embedded cost deprives them of the ability to recover their investment and constitutes a "taking" of property in violation of the ILECs' Fifth Amendment rights. The ILECs' appeal of the FCC ruling is currently pending before the United States Supreme Court (*Verizon Communications, Inc. Et Al., Petitioners, vs. Federal Communications Commission, Et Al.*, Docket Nos. 00-511, 00-555, 00-590and 00-602, argued October 10, 2001).

11. *In the Matter of Access Charge Reform,* CC Docket No. 96-262, *Price Cap Performance Review for Local Exchange Carriers,* CC Docket No. 94-1, *Transport Rate Structure and Pricing,* CC Docket No. 91-213, *Usage of the Public Switched Network by Information Service and Internet Access Providers,* CC Docket No. 96-263, Notice of Proposed Rulemaking, Third Report and Order, Notice of Inquiry, Rel. December 24, 1996 ("*Access Charge Reform NPRM*").

> return the incumbent LEC earnings on the investment portion of the costs designated for recovery, or to increase the incumbent LEC's price cap sharing obligation, given the limited risk of non-recovery under such a mechanism. Alternatively, we could permit incumbent LECs to select from two recovery options– cost recovery through market-based prices to the extent they are able in a competitive market; or cost recovery through a regulatory mechanism, with a greater sharing obligation under the price cap plan.[12]

Unfortunately, the FCC has thus far not pursued this "make whole vs. make money" concept, with the result that the RBOCs *are* being allowed to have it both ways. The current RBOC "price cap" regime, most recently revised in the so-called "CALLS settlement,"[13] did not require a reinitialization of rates so as to reduce the earned return on *embedded* ILEC investment to the "authorized" competitive level,[14] and BOCs continue to earn well in excess of 425% on their *interstate* services — a monopoly earnings level that could not be sustained under competitive market conditions. Moreover, even this overly generous *CALLS* regulatory regime does not even apply to services that have been deemed "competitive" and as such are subject to "pricing flexibility" outside of *CALLS*.[15] And, of course, all of the *Bellfare* programs that sustain and enhance RBOC earnings levels continue to exist and to expand.

Like pigs feeding at the public's trough, the BOCs' appetite for government handouts and special regulatory privileges and concessions never seems to be satiated. Existing subsidies become entitlements, and new demands for special treatment are put forth so as to provide the Bells with a "fair opportunity to compete" against largely nonexistent competitors, or to "protect" the RBOCs from fantasized competitive encroachments and other business conditions that they seek to attribute to the nation's competitive telecommunications policy. But rather than affording the incumbents a fair opportunity to compete and to earn a fair return on their investments, these pervasive corporate welfare programs have worked to finance and to sustain massive and widespread cross-subsidization and other anticompetitive conduct directed precisely at those segments of RBOC business in which competition —actual or potential — is present.

Bellfare has conferred enormous financial value to these companies while diverting value and resources from the balance of the economy. In this paper, I identify and quantify ten of the largest

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12. *Id.*, at para. 265.

13. *In the Matter of Access Charge Reform,* CC Docket No, 96-263; *Price Caps Performance Review for Local Exchange Carriers*, CC Docket No. 94-1; *Low-Volume Long Distance Users*, CC Docket No. 99-249; *Federal-State Joint Board On Universal Service*, CC Docket No. 96-45, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1; Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45, Rel. May 31, 2000 (*"CALLS Order"*).

14. The "authorized" return on ILEC investment in the interstate jurisdiction was last set by the FCC in 1990, at 11.25%. *In the Matter of Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers,* CC Docket No. 89-624, Order, Rel. December 7, 1990, at para. 1. On the basis of interest rates and capital market conditions extant today, even that "authorized" level would be considered excessive.

15. *In the Matter of Access Charge Reform, CC Docket No. 96-262; Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1; *Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers*, CCB/CPD File No. 98-63; *Petition of U S West Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA*, CC Docket No. 98-157, Fifth Report and Order and Further Notice of Proposed Rulemaking, Rel. August 27, 1999 ("*Pricing Flexibility Order*").

Bellfare programs, whose value to the BOCs can be conservatively estimated to represent nearly $170-billion in additional capitalized shareholder value. These concessionary or exclusionary rules and programs range from permissions to impose exorbitant rates on wholesale and retail customers, to grants of free use of the public's property such as rights-of-way and electromagnetic spectrum. As this study shows, when quantified and aggregated, these *Bellfare* benefits account for much of the current financial health — and wealth — of the RBOCs. Originally designed to ensure that the local telephone monopolies remained financially viable, the myriad of concessions and exclusionary rules fashioned over the last twenty years now work primarily to ensure that the RBOCs *remain monopolies* and — in stark contrast with the regulatory regime in place during the "official" monopoly era — these programs now not only *allow* the BOCs to charge supracompetitive prices and to earn monopoly rents regardless of nominal competitive pressures, but virtually assure precisely this outcome. The RBOCs are thus virtually guaranteed gluttonous monopoly profits, while CLECs are forced to scavenge for scraps in the competitive marketplace. As a result of their years of history as regulated and protected monopolies, the RBOCs are in the charmed position of being able to extract fat profits from their local markets without fear that their control of these markets will be effectively challenged by competitors.

Because these regulatory "givings" have provided RBOC stockholders and management with massive and continuing financial transfusions from their customers and their rivals, it is little wonder that the RBOCs aren't feeling the pinch of the telecom market's current troubles.

Calculating the value of RBOC corporate welfare

This paper examines each of the "top ten" corporate welfare programs directed at and benefitting RBOCs. As described below, estimates of the annual earnings impact attributable to each *Bellfare* program were made for each program, and capitalized values were then calculated using the 11.25% rate of return last authorized by the FCC. Table 1 presents the results of this analysis for the "Top Ten" *Bellfare* programs.

Table 1

Conservative Estimate of the Value of Corporate Welfare ("Bellfare") Programs Granted to the Regional Bells

Rank	Bellfare program	Annual value	Capitalized value
1	Switched access rates in excess of economic costs	$9.92-billion	$57.79-billion
2	Free nationwide cellular licenses	$4.68-billion	$27.27-billion
3	Dedicated access rates in excess of economic costs	$3.87-billion	$22.57-billion
4	Monopoly rents derived from Yellow Pages directory business	$2.81-billion	$16.38-billion
5	Ability to terminate ISP-bound calls at below-cost rates	$1.78-billion	$10.39-billion
6	Ability to offer interLATA vertical features without compensating IXCs	$1.70-billion	$9.94-billion
7	Competitor-financed universal service subsidies	$1.56-billion	$9.12-billion
8	Restrictions on competition for small business customers	$1.23-billion	$7.17-billion
9	Ability to preferentially market own long distance services	$1.11-billion	$6.48-billion
10	Unregulated provision of billing and collection services	$0.20-billion	$1.17-billion
"Top Ten" total		$28.86-billion	$168.28-billion

The aggregate capitalized value of these ten *Bellfare* programs is $168.28-billion. This result is decidedly *conservative* for at least two reasons: First, as described below for each of the individual analyses, highly conservative assumptions have been employed in applying the source data and in estimating the annual value. Second, the analysis here is necessarily limited to these specific categories of corporate welfare being directed at the RBOCs — there are a number of others that are not being addressed in this paper. But to appreciate the significance of these conservative estimates of the subsidies received by the RBOCs, note that total annual RBOC revenues associated with local

service are in the $100-billion range. Thus, these subsidy programs — which themselves account for nearly $30-billion annually — are responsible for a very substantial portion of total RBOC revenues.

The following sections describe in greater detail each of these "Top Ten" *Bellfare* programs. For each, there is first a brief description and history of the program, followed by a description of the quantitative methodology used to establish the dollar value of the program to the RBOCs. Current annual benefits are then capitalized so as to provide an estimate of the impact of each *Bellfare* program on the value of RBOC stock.

Bellfare Program: ***Carrier and end-user switched access rates that exceed the economic cost of these services***

Description: "Access charges" is the term of art used to describe payments that are made by IXCs and end-users to LECs for long distance call origination and termination. To the extent that these rates remain above their economic cost, LECs receive subsidies from their competitors and their end-users.

History: Although the access interconnection services that are sold by the LECs to IXCs and end-users for long distance calling are technically identical to the interconnection services that are required by Sections 251 and 252 of the 1996 *Act* to be provided by the LECs to CLECs or CMRS carriers for local call termination, the pricing of "access" is completely different.[16] The pricing of access services has been (and continues to be) governed by arbitrary jurisdictional separations rules, residual ratemaking practices, and historical cost accounting, as well as the largely historic and by now certainly antiquated notion that above-cost access prices somehow "benefit" consumers by enabling ILECs to set basic local residence service rates lower than they would otherwise be.[17] As a result, access prices are greatly in excess of equivalent local interconnection prices, which are to be based upon forward-looking economic cost.

The access rates most egregiously in excess of cost are those charged on intrastate interLATA calls. And although the CALLS plan that was adopted

16. In fact, Sections 251 and 252 are strictly limited to *local* services only. ILECs are not obligated to apply cost-based prices for "access services" that are used in connection with interexchange (long distance) calling. *In the Matter of Access Charge Reform,* CC Docket No. 96-262*; Price Cap Performance Review for Local Exchange Carriers,* CC Docket No. 94-1*; Transport Rate Structure,* CC Docket No. 91-213; and *Pricing End User Common Line Charges*, CC Docket No. 95-72, First Report and Order, Rel. May 16, 1997, at para. 44.

17. James Prieger, "Universal Service and the Telecommunications Act of 1996: The fact after the act," *Telecommunications Policy,* Vol. 22, Number 1, 1998, at 60. In fact, when all elements of basic residential exchange service are considered — including vertical features, local and intraLATA usage charges, directory assistance revenues, and revenues from ancillary deregulated services such as voice mail and inside wire maintenance, total residence revenues are well in excess of cost — both economic and embedded — and no access charge subsidy is required. But by perpetuating the "myth" that high access charges keep basic rates low, the RBOCs have been allowed to exploit their monopoly control over this essential service and to flow the supracompetitive profits derived therefrom directly to their bottom line.

in 2000 by the FCC did work to reduce, in some cases substantially, rates for interstate access,[18] even these "CALLS" rates also remain in excess of costs as calculated by the FCC's Synthesis Model. Furthermore, because many of the reductions in access payments made by IXCs have been counterbalanced by increases in access fees imposed upon end-users (so-called "Subscriber Line Charges" ("SLCs")),[19] these end-user access fees also substantially exceed the economic costs they are intended to recover.

Quantification: The FCC reports that ILECS currently receive $5.20-billion in interstate switched access charges and $6.20-billion in intrastate switched access charges, totaling some $11.4-billion.[20] These payments purchase approximately 792.2-billion access minutes,[21] yielding an average access charge per minute of $0.0144. But because the FCC's own Synthesis Model shows the economic cost of this access to be only $0.00246 per minute,[22] the LECs are receiving $0.01194 per minute in subsidy. When multiplied by the 792.2-billion access minutes that IXCs purchase, the total carrier-paid switched access subsidy received by the LECs is $9.46-billion per year.

FCC reports and LEC-filed tariffs show that end-users pay $11.33-billion per year in interstate subscriber line charges on 168-million subscriber lines.[23] This amounts to $5.62 per line per month. These charges are intended to

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18. *CALLS Order*, at para. 185.

19. *CALLS Order,* at para. 30.

20. Federal Communications Commission, Wireline Competition Bureau, Industry Analysis Division, *Telecommunications Industry Revenues 2000 Report*, Tables 5, line 304a.

21. Federal Communications Commission, *Statistics of Communications Common Carriers*, 2000/2001 Edition, Table 2.6. This number contains only interLATA intrastate and interstate minutes, however, since most intraLATA traffic is carried by the RBOCs, this data would have little effect on the total amount of access charge subsidy. In addition, the ILECs' above-cost intrastate switched access charges also work to permit the same ILECs to maintain commensurately excessive prices on their own intraLATA toll services. In fact, under "imputation" rules in effect in most states that were established to prevent the ILECs from perpetrating a "price squeeze" on competing providers of intraLATA toll services, ILECs are actually *required* to set their own intraLATA toll prices so as to recover what would be the applicable access charge were the ILEC required actually to pay it to itself. Thus, the $6.8-billion per year in *access charge subsidy* does not include the corresponding amount implicit in intraLATA toll pricing.

22. A description of the adjustments required to convert the FCC's universal service Synthesis Model (see http://www.fcc.gov/wcb/tapd/hcpm/welcome.html) are presented in Ex Parte letter from Robert W. Quinn, Jr., AT&T to Magalie Roman Salas, Federal Communications Commission, CC Docket No. 01-9, February 1, 2001, and *Application of Verizon for Authorization To Provide In-Region, InterLATA Services in Pennsylvania*, Memorandum Opinion And Order,("Pennsylvania Order") CC Docket No. 01-138, September 19, 2001, n. 249.

At my request, AT&T ran the UNE-adjusted FCC Synthesis Model for the 95 non-rural ILEC study areas in the United States and Puerto Rico. An average cost for dedicated transport switched access was developed by weighting the model's output for this figure across study areas based on their relative amounts of dedicated access interLATA toll MOU. An average cost for tandem switched access was developed by weighting the model's output for this figure across study areas based on their relative amounts of tandem access interLATA toll MOU. An overall average access cost per minute was then computed by weighting the dedicated access figure by 80% and the tandem access figure by 20%.

23. July 2001 Annual Access Filing.

cover 25% of the cost of subscriber loops and ports.[24] The FCC's Synthesis Model shows that 25% of the economic cost of these LEC network elements is only $4.07 per line per month.[25] Thus, ILEC end-user access subsidy receipts are $1.55 per line per month, or $3.12-billion per year.[26]

Total carrier and end-user paid switched access subsidies then sum to $9.92-billion per year. The present value of these subsidies, capitalized over ten years at the RBOCs' 11.25% authorized rate of return, is $57.79-billion.

Annual Value: $9.92-billion

Capitalized Value: $57.79-billion

Bellfare Program: ***Free nationwide cellular licenses***

Description: The RBOCs were granted the so-called B-side 25 MHz spectrum slice in the 850 MHz band to offer cellular services to the public.[27] This wireless license was granted to the ILECs without charge and, for the most part, on a noncompetitive basis.[28] Beginning in 1993, the FCC made additional

24. *CALLS Order,* at para. 11.

25. At my request, AT&T ran the UNE-adjusted FCC Synthesis Model for the 95 non-rural ILEC study areas in the United States and Puerto Rico. An average cost for loops plus switch line ports was developed by weighting the model's output for the sum of these figures across study areas based on their relative numbers of switched lines. This 25% of the total figure of $16.30 was then used to represent separated interstate economic cost.

26. Because, among other things, the lines and minutes data underlying the Synthesis Model are stale and undercount significantly current RBOC volumes, the Synthesis Model fails to recognize many of the scale economies currently exploited by the RBOCs. Thus, actual RBOC economic costs of providing loops, ports and access minutes are likely much smaller than the Synthesis Model figures used here. This suggests the true amount of RBOC subsidies from switched access exceed these figures.

27. *See Cellular Communications Systems*, *Order and Reconsideration*, 89 FCC 2d 59, 86-89 (1982) (*"1982 Cellular Order"*); see also 47 CFR 22.2; Rural Cellular Service Radio, 4 FCC Rad. 5272, 5274 (1988).

28. Under the FCC's *1982 Cellular Order*, nonwireline and wireline applicants were required to "compete" for their respective licenses, but only within their own group. *In the Matter of An Inquiry Into the Use of the Bands 825-845 MHz and 870-890 MHz for Cellular Communications Systems; and Amendment of Parts 2 and 22 of the Commission's Rules Relative to Cellular Communications Systems,* CC Docket No. 79-318, Report and Order, Rel. May 4, 1981, at para. 29. Nonwireline applicants in the largest markets were required to engage in protracted and costly litigation or enter into full market settlements under which each applicant received a proportionate interest in a full market partnership. Wireline applicants for the B-side licenses were limited to companies that provided regulated monopoly local telephone service within the defined cellular market area (generally a single Metropolitan Statistical Area), which worked to limit the number of potential wireline applicants to one or a handful, in which event full market settlements could be quickly and easily achieved. Besides obtaining their licenses quickly and at no cost, the ILEC licenses were able to build out their systems and to commence their operations anywhere from one to three years ahead of their A-block nonwireline competitor, affording the ILEC licensee a formidable head-start market advantage over its later-to-enter rivals.

wireless spectrum available,[29] but only after Congress required the FCC to allocate wireless spectrum via an auction process.[30] As a result, the overwhelming majority of PCS providers have had to buy their wireless licenses at auction. And because these non-RBOC wireless competitors must build their spectrum license costs into their prices, the RBOC-owned cellular businesses are able to operate under an enormous price umbrella that permits them to realize consistently excess returns and to do so on a sustained basis.

History: About twenty years ago, when the FCC was first authorizing the provision of cellular telephone service, it granted spectrum licenses gratis. The first two licenses granted (referred to as the A- and B-side licenses in the 850 MHz band) gave each recipient rights to use a 25 MHz slice of this band. The A-side licenses were available to *non-wireline* applicants, i.e., to applicants that were *not* regulated monopoly local telephone companies. Licenses for the ninety largest markets were awarded either via a competitive hearing process or through full market settlements; the remaining A-side urban and rural cellular licenses were doled out by lottery. B-side licenses were "set-aside" for franchised local telephone utilities, and were generally granted on a non-contested basis. Ultimately, some 730 Metropolitan Service Area (MSA) and Rural Service Area (RSA) licenses were handed out without charge and with little or no competition to incumbent wireline telephone companies. Taken together, these 730 MSA and RSA licenses virtually blanket the entire United States.

In 1993, the US Congress passed legislation requiring that the FCC auction off competing PCS spectrum in the 1850-2000 MHz band. The major commercial pieces of this spectrum were separated into three 30 MHz slices (called the A, B and C blocks). The A and B blocks were auctioned in early 1995. The C block was auctioned one year later. But because numerous bidders who had won over 50% of the C-block licenses (e.g., NextWave) defaulted on their payments, the FCC reauctioned these licenses in early 2001. This auction provides the most recent and comprehensive data available on the market value of US wireless spectrum.

Quantification: The NextWave C-block licenses, representing the equivalent of 50.96% of a national footprint, were reauctioned in 2001 for $13.9-billion.[31] Grossed up to a national basis, the current (2001) value of a nationwide license would

29. *In the Matter of Amendment of the Commission's Rules to Establish New Narrowband Personal Communications Services,* GEN Docket No. 90-314; ET Docket No. 92-100; RM-7617, RM-7760, RM-7782, RM-7860, RM-7977, RM-7978, RM-7979, RM-7980, PP-4, PP-5, PP-11, PP-14, PP-35 through PP-40, PP-53, PP-69, PP-79 through PP-85, First Report and Order, Rel. July 23, 1993.

30. *Omnibus Budget Reconciliation Act of 1993*, Pub. L. No. 103-66, Title VI, §§ 6002(b), 107 Stat. 312 (1993)

31. *See* http://wireless.fcc.gov/auctions/35/carts/35cls3.pdf. (Accessed 3/15/2002). Figure is a sum of payments for C block licences.

then be $27.27-billion.[32] This represents the value that should be imputed to the free cellular spectrum that was provided to the RBOCs. If the RBOCs had to pay for this spectrum over ten years, its annual cost to them would be $4.68-billion.[33]

Annual Value: $4.68-billion

Capitalized Value: $27.27-billion

Bellfare Program: ***Carrier and end-user dedicated (special) access rates that exceed the economic cost of these services***

Description: "Special Access" is the term used to describe dedicated (non-switched) lines used by IXCs and end-users for data traffic or to originate or terminate relatively large volumes of long distance calls. To the extent that special access rates remain above their economic cost, ILECs receive subsidies from IXCs and from the IXCs' end-user customers.

History: Although the dedicated line interconnection services that IXCs or end-users purchase from the LECs for special access purposes are technically identical to the dedicated line interconnection services that CLECs or CMRS carriers use to connect to LEC networks, the pricing is completely different. The pricing of special access services has been (and continues to be) governed by arbitrary jurisdictional separations rules, residual rate-making practices and historical cost accounting. As a result, special access prices are greatly in excess of equivalent local interconnection prices, which are required to be based on forward-looking economic cost.

Quantification: FCC reports and LEC-filed tariffs show that IXCs and end-users currently pay $9.48-billion per year in interstate special access charges and $3.43-billion in intrastate special access charges, totaling $12.91-billion.[34] However, the pricing of this special access is significantly greater than its eco-

32. Although the PCS spectrum that was reauctioned in 2001 involved 30 MHz band rather than the 25 MHz of spectrum that was given away to the ILECs in the 850 MHz of spectrum in the 1900 MHz band, I have assumed for purposes of this calculation that the two are roughly equivalent in value. While the 30 MHz bandwidth allocated in the 1.9 GHz PCS frequency spectrum is slightly larger than the 25 MHz bandwidth allocated to A-block 850 MHz wireline licensees, the decidedly inferior signal propagation properties at the higher PCS frequencies, which require many more transceiver sites than in the lower cellular band, likely more than offset the larger bandwidth. In fact, treated the 30 MHz PCS bandwidth as equivalent in value to the 25 MHz cellular bandwidth likely understates the actual market value of the "free" spectrum that was given away to the RBOCs.

33. This calculated value of the RBOC B-side cellular licenses is based only upon US auction data. If these license values are computed based upon most recent auctions of 3 GHz spectrum in Europe, the suggested values would be substantially higher.

34. Federal Communications Commission, Wireline Competition Bureau, Industry Analysis Division, *Telecommunications Industry Revenues 2000 Report*, Tables 5 line 305 and Table 6 line 406. Adjustments have been made to account for rate of return regulated ILECs.

nomic cost. Conservatively, it is possible to estimate the cost to the RBOCs of providing this service as constituting 70% of its price.[35] Thus, the LECs receive a special access subsidy of $3.87-billion per year. The present value of this subsidy, capitalized over ten years at the RBOC's 11.25% authorized rate of return, is $22.57-billion.

Annual Value: $3.87-billion

Capitalized Value: $22.57-billion

Bellfare Program: ***Diversion of monopoly rents from Yellow Pages advertising away from their traditional role as providing support for basic residential service to the RBOCs' "bottom line."***

Description: If a carrier is a monopoly RBOC, it is in a unique position to receive in-excess-of-cost rents from its Yellow Pages business. There are several reasons. First, like many newspapers and other advertising media, yellow page directories possess an economic attribute known as "network externalities." Generally, products/services of this type have a tendency to support only a single provider. The reason for this phenomenon can best be explained by thinking of the directory product as performing a "switching" or an "exchange" function, bringing advertisers together with users and transferring information from the former to the latter. The demand exhibited by individual advertisers and consumers for a particular yellow pages directory, like that for many other products and services that perform switching or exchange functions, is heavily influenced by the actions of other advertisers and consumers with respect to the product. In economic theory, such demand is said to be influenced by "externalities;" that is, one's demand for access to the "information exchange" function supported by a given yellow pages product is heavily influenced by the aggregate number of *other* advertisers and users who participate in the exchange. Advertisers are more willing to advertise in, and pay higher rates for, directories with large, perhaps ubiquitous circulation; consumers are more likely to select the directory that has the largest compilation of listings and advertisements. Once a product has achieved this "critical mass," it is virtually impossible for a competing directory publication to break into the market. In the case of yellow pages directories, that "critical mass" was achieved decades ago, when the ILECs were legally sanctioned franchise monopolies. For this reason, no start-up directory publication can come even close to achieving the level of user and advertiser acceptance and penetration that can be found in the incumbent LECs' books. It is thus not surprising that competitors' efforts to break into this market have for the most part be met with failure,

35. The actual discrepancy between the cost of special access and its interstate tariff rate is likely to be much higher. A comparison of the recently set Verizon New York cost-based UNE rates and the Verizon New York interstate special access tariff indicate that, for DS1 and DS3, depending on the length of the circuit, costs range from 21.65% to 54.8% of special access prices.

largely because the RBOC-owned Yellow Pages publisher has comprehensive and immediate information about the businesses located in its service area (extracted by the RBOC when a business signs up for local service) that is practically unavailable to competitive suppliers. Thus, because customers and advertisers have mutually gravitated to the single, comprehensive RBOC directory, the RBOC Yellow Pages book maintains an insurmountable advantage over any present or future competing publication.

History: Prior to the break-up of the former Bell System, state regulators required that yellow pages advertising profits be included in calculating the BOCs' "revenue requirements." The effect of this policy was to have use the enormously profitable yellow pages publishing activity as a source of support for below-cost residential exchange services. When the draft *Modification of Final Judgment* was first presented to the United States District Court on January 8, 1982, the notion was that monopoly lines of business — principally local exchange service and associated carrier access services — would remain with the BOCs, while the potentially competitive services would stay with AT&T. Because the yellow pages business was not a *de jure* monopoly, the original Bell System divestiture plan placed this activity in the post-divestiture AT&T rather than in the Bells.[36] However, because yellow pages profits had been used to subsidize basic residential exchange service, state regulators in particular argued that the Baby Bells sought to retain that source of subsidy and urged Judge Greene to order that the Yellow Pages, and their monopoly profit streams, remain with the Baby Bells and that they be used to support below-cost local residential telephone rates. That position was ultimately adopted by the divestiture Court.[37]

Immediately after divestiture and notwithstanding the unambiguous rationale for Judge Greene's ruling, the RBOCs commenced what became a highly successful campaign to have their Yellow Pages businesses removed from their regulatory books, and to have the profits — which were supposed to go to subsidize basic exchange service — become the sole property of RBOC

36. *U.S. v. AT&T*, 552 F. Supp. 131, 143 (D.D.C. 1982)

37. In his Order adopting the MFJ issued August 24, 1982, Judge Greene concluded that the yellow pages "provide a significant subsidy to local telephone rates [that] would most likely continue if the [BOCs] were permitted to continue to publish the Yellow Pages."(*U.S. v. AT&T*, 552 F. Supp. 131, 193-194 (D.D.C. 1982)). He went on to state:

> The loss of this large subsidy would have important consequences for the rates for local telephone service. For example, the State of California claims that a two dollar increase in the rates for monthly telephone service would be necessary to offset the loss of revenues from directory advertising. Other states assert that increases of a similar magnitude would be required.

Id., at 194.

stockholders. With only a handful of exceptions,[38] this "below-the-line" status of the yellow pages business has persisted to the present.

Quantification: The goal is to determine the value of ILEC-owned Yellow Pages businesses that is in excess of the value these businesses would have if they were operated by a competitive (non-ILEC) publisher. This represents the value that the RBOCs' Yellow Pages businesses gain from their affiliation with the RBOC local exchange monopolies.

RBOC 10-K reports filed with the SEC show their total annual Yellow Pages and other directory revenues to be $12.24-billion in 2000. These reports also show operating expenses attributable to this business segment to be $5.8-billion — yielding an annual EBITDA of $6.45-billion.[39]

We have two sources of information about competitive Yellow Pages financials. One derives from a comparable firm, R. H. Donnelley and Company, that publishes Yellow Pages directories; the other is from the recent transaction in which a CLEC, McLeodUSA, sold its directory publishing business to another competitive publisher for $600-million.[40] R. H. Donnelley revenues were $898-million in 2000 and its EBITDA was $163-million.[41] During that same year, its enterprise stock market value was $640-million – representing a multiple of 3.93 on its EBITDA.[42] This suggests that the enterprise value of Yellow Pages publishing businesses in general is 3.93 times their EBITDA. Because the RBOC Yellow Pages EBITDA is $6.45-billion, the enterprise value of this RBOC business would be 3.93 times that amount, or $25.35-billion.

The next task is to segment this enterprise value of the RBOCs' Yellow Pages publishing business into its competitive and supra-competitive portions. Because R. H. Donnelley (a competitive company) has an EBITDA to revenue ratio of 0.1814, while the RBOC ratio is 0.5266, this suggests that 34.44% of the RBOC Yellow Pages enterprise value is competitive, while the

38. *See*, e.g., *In the Matter of the Application of Pacific Northwest Bell Telephone Company (PNB) to Merge With the Mountain States Telephone and Telegraph Company (MTN) (To Be Renamed US West Communications Inc.) (USWC), and for USWC to Assume Debt of PNB and to Issue Securities Under Authorization Previously Granted but Not Fully Utilized by PNB,* Washington Utilities and Transportation Commission, Docket No. U-89-3524-AT, 1990 Wash. UTC LEXIS 120, November 9, 1990, at 14-15.

39. Data from *Form 10K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934,* fiscal year ended December 31, 2000 for Verizon, BellSouth, Qwest, and SBC.

40. McLeodUSA Press Release, "McLeodUSA Signs Definitive Agreement With Yell Group for $600 Million Purchase of Telephone Directory Publishing Business," January 21, 2002.

41. R.H. Donnelley Corporation, *Form 10K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934,* fiscal year ended December 31, 2000.

42. Stock value is based on a rough yearly average assuming a share price of $20 and 32 million shares outstanding.(Source: Yahoo!Finance (http://finance.yahoo.com/?u))

remaining 65.56% represents its supracompetitive (monopoly) value. This latter amount equals $16.62-billion.

As an alternative, assuming that the steady-state level for McLoedUSA's directory publishing EBITDA is the level that it would achieve if its current growth rate would continue for five more years, and applying the same valuation methodology as for R. H. Donnelley, yields an estimate of the supracompetitive value of RBOC Yellow Pages of $16.14-billion.

Averaging these two estimates of the supracompetitive value of RBOC Yellow Pages yields a capitalized figure of $16.38-billion. Annualized over ten years at 11.25%, this would be equivalent to an annual excess profit flow of $2.81-billion from RBOC Yellow Pages.[43]

Annual Value: $2.81-billion

Capitalized Value: $16.38-billion

Bellfare Program: ***Ability to terminate ISP-bound calls at concessionary rates***

Description: ILECs are allowed to terminate calls originated by their end-users to ISPs served by CLECs at rates less than the ILECs' avoided incremental costs.[44]

History: The *Telecommunications Act* requires ILECs to pay reciprocal compensation to CLECs if an ILEC-originated call is terminated on the CLEC's network, and vice versa.[45] Immediately after the Act was passed in 1996, the ILECs (believing that they would be terminating more calls from CLECs than vice versa) began to "negotiate" reciprocal compensation rates that were greatly in excess of the ILEC's cost of call termination. As it turned out, the ILECs' traffic pattern forecasts were wrong, as CLECs were successful in signing up ISPs (who receive far more calls than they place) as customers. Thus, the ILECs began to pay out more in reciprocal compensation than they received. The ILECs were then able to importune the FCC to assert jurisdiction over ISP-bound calls, and to require (after a short transition period) the ILECs to

43. Indeed, alternative valuation methodologies lead to much higher implied values for RBOC Yellow Pages franchises. According to US West's Annual Report for 1999, its Directory Services margin was $0.7 billion, or 39% of US West's total operating margin. Because Qwest paid $44.1 billion to acquire US West in 2000, this suggests the enterprise value of US West's Yellow Pages business to be $17.2 billion. Assuming, again, that 65.56% of this enterprise value is its supra-competitive component. The supra-competitive value of US West's directory business was $11.3 billion. Because US West represents only about 13% of the total RBOC industry, this implies the supra-competitive value of the total RBOC Yellow Pages business is $86.6 billion.

44. *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996,* CC Docket No. 96-98, *In the Matter of Inter Carrier Compensation for ISP-Bound Traffic*, CC Docket No. 99-68, Order on Remand and Report and Order, Rel. April 27, 2001, ("*Recip. Comp. Order"*) at para. 80.

45. 47 U.S.C. §251(b)(5).

pay only $0.0007 per minute to CLECs to terminate these calls[46] – even though the FCC's Synthesis Model showed the cost of this call termination to the ILEC to be nearly triple that amount — i.e., about $0.0021 per minute.

Quantification: The FCC's Synthesis Model shows the ILECs' cost of call termination to be $0.0021 per minute, or $0.0014 per minute in excess of the rate the FCC permits the ILECs to pay to CLECs for such services. Because the RBOCs estimate that in 2002 residences will generate 1.35-trillion ISP-bound minutes that will be terminated by CLECs,[47] and because at least 95% of these minutes are generated by ILEC end-users,[48] the ILECs' cost savings from being able to pay CLECs below-cost rates for call termination are in the range of $1.78-billion per year. Capitalized over ten years, this represents some $10.39-billion in excess RBOC value.[49]

Annual Value: $1.78-billion

Capitalized Value: $10.39-billion

Bellfare Program: ***Ability to offer interLATA vertical features without payment to IXCs for carriage of the calling party's number (CPN)***

Description: Some of the most valuable of the vertical features offered by LECs to their terminating customers are those that use calling party number (CPN). These vertical features include Caller ID, selective call blocking, call trace, and call return, and feature combinations such as call waiting caller ID and call waiting/caller ID/voice mail. Some of these services (e.g., voice mail) are typically not regulated even when linked specifically to a monopoly vertical feature such as call waiting or caller ID, and in many jurisdictions the rates for all of these features, while nominally "regulated," are subject to considerable pricing flexibility with no obligation on the part of the ILEC to flow any portion of the profits therefrom back to the basic residential dial tone access line. Other than for the purpose of enabling the terminating LEC to offer CPN-based vertical features to its customer, there is no reason for an IXC to pass CPN to a terminating LEC. In 1994, however, the FCC determined that IXCs should (at their expense) be required to pass CPN on

46. *Recip. Comp. Order,* at para. 78.

47. *Ex Parte Letter from Robert T. Blau to Dorothy Atwood, Chief, Common Carrier Bureau,* Submission of BellSouth, SBC, Verizon, and Qwest in CC Docket No. 99-68, December 22, 2000, at Table 1.

48. *See* FCC News Release, "Federal Communications Commission Releases Data on Local Telephone Competition," February 27, 2002. Stating that CLECs serve 5.5% of all residential customers nationally.

49. Because the FCC's new rules apply a $0.0007 per-minute rate only to limited levels of "grandfathered" reciprocal compensation traffic, and permit the ILECs to pay even less for other ISP-bound traffic, these calculated figures are extremely conservative. *Id.* fn 64. Indeed, the FCC has even called for "bill-and-keep" rules to govern such traffic, in which case the annual subsidy to the ILECs would be $2.84-billion, or 60% higher.

to terminating LECs, and expressly prohibited IXCs from charging terminating LECs for this service. The terminating LECs' ability to provide CPN on incoming calls to its customers substantially increases the value (to the customer) of these CPN-based features, and serves both the expand the overall demand for these service features as well as to increase customers' willingness-to-pay for them. This "free" service that IXCs are required to furnish to ILECs thus expands ILEC profit opportunities with no financial return to the IXCs.

History: Most modern vertical features cannot be provided effectively unless the affected calls are originated, transited and terminated on SS7-controlled networks. Prior to 1990, most local networks were not controlled by SS7; thus, the ILECs' ability to offer vertical features was limited. This changed in the early 1990s when 800 number portability required LECs to implement SS7. While this immediately gave the ILECs the ability to offer vertical features on local calls, because the ILECs were unwilling voluntarily to pay IXCs for the delivery of CPN on long distance calls, these features were not operational on such calls. As a result, many end-users questioned the value of vertical features and did not purchase them. In 1994, the FCC required IXCs to pass CPN on to the terminating ILEC free of any charge for this service.[50] As a result, the value of vertical features to customers was greatly enhanced, and the LECs were able to sell these services to more customers and at higher rates than would be supported if the features were operational only on local calls.

Quantification: TNS billing data show that RBOC average vertical features revenue is $6.76 per line per month.[51] Roughly two-thirds of this feature revenue ($4.51 per month) is associated with CPN-based features,[52] and 18% of all calling is interLATA,[53] so the LEC feature revenues associated with interLATA CPN-based features can be estimated at $0.81 per line per month. Multiplying this

50. *In The Matter Of Rules and Policies Regarding Calling Number Identification Service -- Caller ID,* CC Docket No. 91-281, Report and Order and Further Notice of Proposed Rulemaking, Rel. March 29, 1994, at para. 17 & 23.

51. TNS Telecoms Request, market research reflecting the period 1Q2001 thru 3Q2001

52. Assumption based on vertical features available and relative popularity.

53. 2000 ARMIS 43-08, Table IV– Telephone Calls, run using totals from all carriers and columns "local calls," "IntraLATA toll completed," and "IntraLATA toll completed." IntraLATA and InterLATA totals were then inflated to account for uncompleted calls, assuming a call completion rate of 70%. This is a conservative estimate, since it does not include the RBOC revenues from IXC carried intraLATA calls.

monthly figure by the approximately 175-million switched lines in 2000 suggests annual extra revenue (and profit) to the ILECs of $1.7-billion.[54] Capitalized over ten years, this yields the ILECs $9.94-billion in extra profits.

Annual Value: $1.7-billion

Capitalized Value: $9.94-billion

Bellfare Program: ***Competitor-financed "universal service" subsidies***

Description: Both the FCC and several state commissions operate "universal service" funds that are used to subsidize explicitly the RBOCs' provision of local service. Notwithstanding legal requirements to the contrary, CLECs have found it extremely difficult to receive any payments from these funds. IXCs are the largest contributors to these funds.[55]

History: The *Telecommunications Act* required that subsidies to the ILECs be made explicit.[56] Current universal service funds are the result of regulatory efforts in this direction. The FCC runs two such funds — the so-called Interstate High Cost Fund and the CALLS fund. Subsidy payments under the first fund are computed pursuant to an arcane combination of economic cost rules and grandfathering (hold-harmless) rules. This fund currently provides the RBOCs with $248-million per year in explicit subsidies.[57] The CALLS fund contributes an additional $522-million per year to the RBOCs.[58] Neither of these funds require the RBOCs to make any particular expenditure or provide any particular service quality in order to receive payments. Neither fund has proven to be portable to in any practical matter to CLECs offering service in RBOC regions. Several state commissions maintain similar subsidy funds, also without any significant obligation on the part of the RBOCs nor effective portability to CLECs.

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54. (($4.51 features revenue*12 months)*18% interLATA calling)*175-million access lines. Access line counts from: 2000 ARMIS 43-08, Table II– Switched Access Lines in Service by Technology, run using totals from all carriers and column "Total Switched Access Lines."

55. FCC News Release, "FCC Takes Next Step To Reform Universal Service Fund Contribution System; Comments Sought on Connection-Based System to Provide Certainty, Reduce Administrative Costs and Avoid Marketplace Distortions," February 14, 2002. (Stating that IXCs' contribute 63% of the universal service fund.)

56. 47 U.S.C. § 254(e).

57. Sum of RBOC support figures as reported by the Universal Service Administrative Company, *Quarterly Administrative Filings*, for quarters 1 through 4, 2000. Available at: http://www.universalservice.org/ overview/ filings/ 2001q4/Appendix%20HC10.xls, http://www.universalservice.org/overview/filings/2001q3/HC12_3Q01_HCM_ by_Study_Area.xls, http://www.universalservice.org/overview/filings/2001q2/HC13_2Q01_2Q01_HCM_by_Study_ Area.xls, http://www.universalservice.org/ overview/filings/2001q1/Appendix%20%20HC12%201Q2001.xls

58. Universal Service Administrative Company, *Quarterly Administrative Filings*, annual support figures. Available at: http://www.universalservice.org/overview/filings/2001q4/Appendix%20HC07.xls

Quantification: FCC data show the sum of FCC-administered funds received by the RBOCs to be $770-million per year.[59] Reports from state commissions show state funds to contribute $794-million per year.[60]

Annual Value: $1.56-billion

Capitalized Value: $9.12-billion

Bellfare Program: ***Restriction on use of unbundled local switching to serve small business customers***

Description: FCC rules permit RBOCs to deny use of TELRIC-priced unbundled local switching UNEs to CLECs for use in serving customers with more than three lines that are located in Density Zone 1 central offices in the top 100 MSAs.

History: In its *UNE Remand Order*, the FCC determined that RBOCs need not provide TELRIC-priced local switching UNEs to CLECs for use in provisioning customers who have more than three lines.[61] Although the *Telecommunications Act* places no restrictions on the availability of UNEs beyond a showing that they are necessary to the provision of service by a CLEC or that an inability to procure them would impair a CLEC's ability to offer the telecom services that it desires, the FCC found that if a customer had more than three lines and was served by an RBOC Density Zone 1 central office in one of the top 100 MSAs, it would be economically feasible for a CLEC either to extend loop facilities to that customer or to establish adequate digital line carrier ("DLC") systems in a collocation cage at that customer's central office and haul that customer's loops to a competitive carrier's switch.[62] Because the costs of extending loop facilities and/or establishing collocation cages and DLC systems is so high, it is highly unlikely that this will ever be done for customers with less than 20 lines. As a result, small business customers with between 4 to 20 lines are unaddressable by UNE-based competition.

59. This figure is a sum of the two amounts cited in footnotes 57 and 58.

60. Data from an informal poll of state universal service programs. Total is the sum of California, Texas and Colorado programs.

61. *In the Matter of the Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, Rel. November 5, 1999, at para. 294 and 299.

62. *Id.*, at para. 297.

Quantification: TNS data show that there are 21.9-million business lines being purchased by customers whose demand is between 4 and 20 lines.[63] Because the RBOCs generally designed density zones to be equal in size, we assume that one third of these lines that are served out of Density Zone 1 central offices in the top 100 MSAs. (The number of Density Zone 1 central offices located outside of the top 100 MSAs is likely negligible.) Thus, we determine that 7.3-million of these lines are unaddressable by CLECs. The FCC reports that the nationwide average price for businesses with a single line in urban areas is $44.45 per month.[64] Of this amount, the RBOCs' TELRIC network cost is $20.82 and its embedded retailing cost averages $6.82.[65] Thus, assuming a multi-line rate similar to the single line rate, the RBOC earns an excess margin of $16.81. If such a line could be lost to a UNE-based competitor, the RBOC would receive $20.82 in wholesale network revenue, and would incur the equivalent in economic costs. Thus, the economic value to the RBOCs from having this customer class insulated from UNE-based competition (and, likely, any other type of competition as well) is $16.81 per line per month. Multiplied by 7.30-million lines, this *Bellfare* program contributes excess annual profits of $1.23-billion to the RBOCs. The present value of this *Bellfare* program, capitalized over ten years at the RBOCs' 11.25% authorized rate of return, is $7.11-billion.

Annual Value: $1.23-billion

Capitalized Value: $7.17-billion

Bellfare Program: ***Ability to preferentially market own long distance service on inbound calls related to local service***

Description: Acquisition of long distance customers is expensive. To attract new customers, long distance companies undertake extensive advertising programs, direct mail, telemarketing, and a variety of special inducements including cash payments, airline miles, and "free" services. But once they receive authority under Section 271 of the 1996 *Act* to enter the in-region long distance market, BOCs are afforded the unique ability to market their own long distance services to customers *who contact the BOC* to order *local*

63. Business line analysis is based upon the business (D&B) info (end of year 1997) that TNS created in support of the Hatfield model.

64. Federal Communications Bureau, Wireline Competition Bureau, Industry Analysis Division, *Trends in Telephone Service*, Rel. August, 2001, Table 14.2.

65. At my request, AT&T ran the UNE Synthesis model for Residential, Business, and Public Switched lines. The weighted average cost of UNE-P lines was calculated as $20.82. The retail rate was calculated using RBOC year 2000 ARMIS 43-03 Reports, Table I, column i, for direct retail accounts (6610, Marketing, and 6620, Service Support) plus retail share of overhead accounts (6120, General Support, 6710, Executive and Planning, and 6720, General and Administrative). The latter are computed by applying the direct retail share of operating expenses, excluding overhead accounts, depreciation and access expenses to these overhead accounts.

telephone service.[66] By exploiting this "inbound channel," the BOCs are effectively handed massive volumes of potential customers "on a silver platter" by virtue of their continuing dominance of the local residential exchange service market.[67] With respect to such "inbound" local service customers, BOCs avoid virtually all customer acquisition costs that ordinarily confront all other long distance companies — advertising, direct mail, telemarketing, and special promotions and inducements.[68] Because ILECs are permitted to market preferentially the services of their own long distance affiliates, long distance marketing costs incurred by RBOCs to acquire these customers are minuscule[69] when compared with the marketing costs faced by independent IXCs that are denied this enormously efficient marketing opportunity.

History: The *Telecommunications Act* allows the joint marketing of local and long distance service by RBOCs after first having obtained section 271 authority to offer in-region interLATA services.[70] The FCC has since determined that this ability to joint market extends to the right to preemptively sell the RBOCs' affiliate's long distance service on all inbound customer-initiated contacts.[71] The FCC thus allows the local BOC service representative to seamlessly bridge from signing up a customer for local service to acquiring the customer for the long distance affiliate. The result has been that in states where the RBOC has obtained Section 271 authority, some 70% of all long distance customers acquired by the RBOC long distance affiliate were

66. *In the Matter of Application of Bell South Corporation, et. al. Pursuant to Section 271 of the Communications Act of 1934, as Amended, to Provide In-Region, InterLATA Services in South Carolina,* CC Docket No. 97-208, Memorandum Opinion and Order, Rel. December 24, 1997, at para. 239

67. According to the most recent FCC *Local Competition* report, ILECs still directly serve some 5.5% of all residential subscribers in their operating areas. See footnote 49, *supra.* According to the US Census Bureau, each year some 17% of the 103-million US households move their residence, thus making 17% of the 94.5% of ILEC-served households "addressable" for long distance marketing purposes on inbound calls placed to ILECs for the purpose of arranging for new *local* phone service. U.S. Census Bureau, *American Housing Survey for the United States in 1999*, Table 2.9.

68. One analysis has put such cost at "up to $300 to $600 in sales support, marketing and Commissions" per customer acquired. See Borna, Claude, "Combating Customer Churn," in *Business and Management Practices,* Vol. 11, No. 3; Pg. 83-85; ISSN: 0278-4831, Horizon House Publications, Inc., Telecommunications Americas Edition (March, 2000).

69. For example, Verizon LD pays Verizon NY $7.71 per representative contact (http://www.verizonld.com/PDFs/JMA34RATES.PDF, accessed 3/18/2002). SBCS pays $9.90 to SBC Telephone Companies for each customer acquisition made by the telco's customer service representatives (http://www.sbc.com/PublicAffairs/PublicPolicy/Regulatory/affdocs/300993.xls, accessed 3/19/2002).

70. 47 U.S.C.§ 272(g)(2).

71. *In the Matter of Application of BellSouth Corporation et. al. Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services in South Carolina,* CC Docket No. 97-208, *Memorandum Opinion and Order,* Rel. December 24, 1997, at para. 237.

obtained via inbound contacts initiated by customers for the purpose of ordering *local* service.[72]

Quantification: Customers acquired via the ILEC sales channel cost almost nothing — by the RBOCs' own estimates, the *fully-distributed cost*, which is necessarily greater than the actual out-of-pocket incremental cost, is in the $7 to $10 range.[73] Assuming that Section 271 authority is ultimately granted in all BOC jurisdictions, and further assuming (conservatively) that ILECs continue to serve 80% of all US households (with the other 20% being served by CLECs), we can estimate the number of "addressable" inbound local service customers at 17% of 80% of the 99.1-million US households with telephone service,[74] or 13.48-million customers each year. Assuming an 82.3% "take rate"[75] for the BOCs' long distance service on these inbound local service contacts, the inbound channel can be expected to generate some 11.09-million new BOC long distance customers annually. Using a very conservative estimate of normal customer acquisition costs at $100 per acquired customer, the equivalent value of these 11.09-million new long distance customers — in terms of avoided acquisition costs — is $1.11-billion annually. Capitalized over ten years, this *Bellfare* benefit represents $6.48-billion in RBOC market value.[76] Note that this analysis is limited solely to *avoided customer acquisition costs*, and does not reflect the potentially enormous value of the preemptive marketing opportunity that is uniquely available only to the RBOCs of their ability to rapidly expand their

72. This 70% estimate was developed on the basis of customer acquisition experienced reported by Verizon during the first year in which it was offering long distance service in New York. Verizon Long Distance claims to have captured a 20% share of the New York market in the first year in which its entry was allowed. "Verizon Communications Posts Strong Results for Fourth Quarter and 2000," Verizon News Release, February 1, 2001. On average, about 30% of residence customers change their PIC in any given year. "J.D. Powers and Associates Reports: Sprint and SNET Top Performers in Residential Long Distance Customer Satisfaction," July 29, 1999. Thus, 6% (20% of 30%) out of Verizon's 20% total long distance market share is attributable to PIC changes made by existing customers of other long distance carriers. The remaining 14% — representing 70% of the total Verizon Long Distance residential customer base — must then be attributable to inbound local service customers selecting Verizon Long Distance at the time that they placed their orders for local service. Since the overall residential relocation rate is 17%, the Verizon Long Distance "take rate" can be estimated at 14%/17%, or 82.3%, of all inbound new local service orders.

73. See footnote 69, *supra.*

74. FCC Common Carrier Bureau, Industry Analysis Division, *Trends in Telephone Service*, August 2001, at Table 8.4. Figure is for 1999, the most recent year for which this statistic is reported.

75. See footnote 72, *supra.*

76. These figures may understate grossly the potential value of this preferential marketing channel to the RBOCs. Rather than assuming the RBOCs will collect only a third of all customers switching carriers, Pacific Bell has suggested, in advertisements announcing plans to provide in-region interLATA service, that it believes it will be able to capture 82% of all customers (Pacific Bell advertisement in the *San Francisco Chronicle*, December 4, 2001). If this is the case, the value of this RBOC subsidy is 146% higher.

long distance customer base and, potentially, to remonopolize the residential long distance market.[77]

Annual Value: $1.11-billion

Capitalized Value: $6.48-billion

Bellfare Program: ***Unregulated provision of billing and collection services***

Description: Because customers strongly prefer a single bill for local and long distance calling, and because the ILEC is generally the only carrier providing local services, the ILECs have been granted an enviable and unregulated opportunity to extract monopoly rents from IXCs in exchange for the privilege of having the ILEC perform billing services on the IXCs' behalf. Since the ILECs' rates for this activity have been deregulated, they are permitted to pocket all of the monopoly profits available from this service.

History: Prior to the 1980s, billing and collection was viewed as a monopoly function of the LECs', and rates for these services were subject to regulation and the revenues derived therefrom were carried "above-the-line" and included in the ILEC's overall revenue requirement. The FCC then determined that the billing and collection service could be considered competitive, and removed any pricing restrictions on the LECs.[78] Because the incremental costs incurred by the LECs in providing billing and collection services to IXCs are minimal, and because customers often demand a consolidated bill, LECs can (and do) price up their billing and collections almost with impunity.

Quantification: In particular, the ILECs' incremental cost of offering billing and collection services to other carriers (e.g., extra paper, extra postage, additional processing and collections expense) is certainly no higher than $0.30 to $0.35 per customer per month.[79] Unregulated monthly payments to LECs for this service exceed $1.00 per customer, and assuming that ILECs bill approximately 25% of IXC customers, the ILECs are estimated to provide about 300-million monthly customer bills per year. This yields excess

77. The depressed values of IXC stocks — companies like AT&T, WorldCom, Sprint, and even Qwest — and particularly when compared with the sustained high values of Verizon, SBC and BellSouth, provide a strong indication that investors anticipate such an outcome to be a real possibility.

78. *In the Matter of Detariffing of Billing and Collection Services,* CC Docket No. 85-88, Report and Order, Rel. January 29, 1986, (*"Billing and Collection Service Order"*) at para. 44.

79. An Administrative Law Judge in Minnesota provided, in a his findings of fact, an estimate of Qwest's incremental billing and collection costs for long distance billing included in bills that would be sent to local customers "may be lower than ten cents per bill page". *In the Matter of a Commission Investigation Into Qwest's Compliance with the Separate Affiliate Requirements of the Telecommunications Act of 1996 (Section 272)*, Minnesota Public Utilities Commission, Office of Administrative Hearings, OAH Docket No. 7-2500-14487-2, Findings of Fact and Conclusions of Law and Recommendations of ALJ Luis, Rel. March 14, 2002, at para. 84.

payments of about $200-million per year. Capitalized over ten years, this amounts to $1.17-billion.[80]

Annual Value: $200-million

Capitalized Value: $1.17-billion

RBOC market capitalization at multiples of book value reflects the value that investors ascribe to the various *Bellfare* programs and to the RBOCs' ability to maintain and to exploit their market power.

The foregoing analysis identifies ten corporate welfare programs whose combined capitalized value amounts to some $168.28-billion. Corroborating the fundamental validity of this analysis is the fact that *all of that capitalized value* — and then some — is fully reflected in the market values that investors ascribe to RBOC stock. As of December 31, 2001, total market capitalization for the four remaining RBOCs (Verizon, SBC Communications, BellSouth, and Qwest International, Inc.) was $345.8-billion.[81] The combined net book value of these four companies as of that same date was $81.4-billion,[82] indicating a market premium over book value of $264.4-billion. There are at least two sources of this enormous premium. Economic theory suggests that the existence of a premium of market value relative to asset cost for a firm is an indication that the firm has market power and the ability to earn supracompetitive profits. But another source of the premium can be traced to the firm's acquisition of valuable business assets at less than their market value or perhaps at no cost at all, as is clearly the case with the RBOCs here. To the extent that the presence of large-scale government subsidies flowing to the RBOCs enhances these firms' ability to extend their market dominance and enhance their economic profit overall, both of these sources clearly contribute to the $264-billion premium value.

The FCC has relied upon the market-to-book ratio as a basis for identifying the presence of market power by using market-to-book as a proxy for a firm's "q ratio."[83] In its *Review of the Radio*

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80. In any event, by focusing only upon the excess profit that the RBOC earns from offering unregulated billiong and collection services to IXCs, this calculation almost surely understates the value of this monopoly RBOC advantage. The RBOCs also use their local telephone bills as a billing and collection mechanism for their own nonregulated businesses such as inside wire maintenance and voice mail, as well as for billing inserts that promote these nonregulated services. Their provision of "free" billing and collection services to these businesses allows them to receive even further monopoly profits and gain a significant cost advantage over competing providers of these same services.

81. Individual market capitalizations were as follows: BellSouth, $71.4-billion; SBC, $125.9-billion; Verizon, $128.9-billion; Qwest, $19.6-billion. Source: Standard and Poor's, *Standard and Poor's Stock Reports,* McGraw Hill, December 2001 (*"Standard and Poor's"*).

82. Book values represent book value per share multiplied by the number of shares outstanding as reported in *Standard and Poor's* (Verizon Book Value per share from Verizon Communications 8-K, Filed February 1, 2002). Individual Book values were as follows: BellSouth, $18-billion; SBC, $28.5-billion; Verizon, $32.5-billion; Qwest, $2.4-billion.

83. Tobin's *q ratio* is the ratio of the firm's market value to the replacement cost of its assets. See, e.g., Maneesh Sharma and Paul D. Thistle, "Is Acquisition of Market Power a Determinant of Horizontal Mergers?" *Journal of Financial and Strategic Decisions* 9 (1996) 45-55, at 47; and Michael Smirlock, Thomas Gilligan, and William Marshall, "Tobin's *q* and the Structure-Performance Relationship," *American Economic Review* 74 (1981) 1051-1060, at 1051; see also FCC, Mass Media Bureau, Policy and Rules Division, *Review of the Radio Industry, 1997*, MM Docket No. 98-35, (continued...)

Industry, 1997, the FCC's Mass Media Bureau noted that when a firm's q ratio is greater than one, a firm is earning economic rents and "it may signal that the firm may not be facing vigorous competition."[84] The FCC also utilized q ratios in its 1994 finding that cable television operators had market power. The FCC there explained that "[u]nder conditions of perfect competition, potential buyers of the assets of a competitive firm which, by definition, does not earn excess economic profits, are unwilling to pay much more than the reproduction cost of the firm's tangible assets."[85] As such, the FCC concluded that the market value of a firm in a competitive market would be approximately equal to the reproduction cost of the firm's assets and that the q ratio of a firm in a competitive market (i.e. no excess economic profits) would equal one and that q ratios greater than one would indicate that a firm or several firms in a market are earning excess profits. "Such a result is consistent with the presence and exercise of market power, inasmuch as excess profits are generated by price-cost margins that are greater than what may be required simply to recover the total cost of production in the presence of economies of scale. If a q ratio is greater than one, then another firm would find it profitable to enter the market. Such entry would increase market supply, force prices and profits down towards a competitive level, and hence, reduce the market value of the incumbent firm or firms. When the q ratio reached one, entry would no longer be profitable."[86] Thus, a value of q — as reflected in a firm's market-to-book ratio — that is well in excess of one and that is actually *increasing* over time is consistent with the sustained and expanding presence of market power, and distinctly *not* with the presence of an effectively competitive market.

At the time of the break-up of the former Bell System, RBOC shares were trading essentially at their net book value, reflecting investors' expectations that, as regulated public utilities, the divested "baby Bells" would continue to earn no more than the authorized competitive return on rate base investment which, at the time, represented the vast majority of all RBOC assets.[87] Following their divestiture, however, the RBOCs were gifted valuable assets and were afforded numerous new

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83. (...continued)
March 13, 1998, at 19. A 1981 study by Lindenberg and Ross showed that *q* provides "an accurate measure of the capitalized value of the rents attributable to both monopoly and other firm-specific factors," and thus market power. Smirlock, Gilligan and Marshall, at 1051, citing E. Lindenberg and S. Ross, "Tobin's q Ratio and Industrial Organization," *Journal of Business* 54 (1981) 1-32. In fact, there is support for the position that Tobin's *q* ratio provides a better measure of monopoly power than do accounting measures. M.A. Salinger, "Tobin's q, Unionization, and the Concentration-Profits Relationship," *Rand Journal of Economics* 15 (1984) 159-170, at 160. Specifically, Smirlock *et al* state that "[t]he use of profit rates, typically calculated as the ratio of accounting profits to book equity, as measures of monopoly rents has been extensively criticized ... Future firm rents, on the other hand, will be appropriately capitalized by an efficient capital market. By combining financial market data with accounting data, a more accurate measure of firm rents can be derived. Tobin's q provides the framework for this construct." Smirlock, Gilligan Marshall, at 1054.

84. FCC, Mass Media Bureau, Policy and Rules Division, *Review of the Radio Industry, 1997*, MM Docket No. 98-35, March 13, 1998, at 19. The literature supports such an interpretation. See, e.g., Maneesh Sharma and Paul D. Thistle, "Is Acquisition of Market Power a Determinant of Horizontal Mergers?" *Journal of Financial and Strategic Decisions* 9 (1996) 45-55, at 50; M.A. Salinger, "Tobin's q, Unionization, and the Concentration-Profits Relationship," *Rand Journal of Economics* 15 (1984) 159-170, at 160-161.

85. *In the Matter of Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992; Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, FCC CS Docket No. 94-48, First Report, Rel. September 28, 1994, at para. 206.

86. *In the Matter of Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992; Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, FCC CS Docket No. 94-48, First Report, Rel. September 28, 1994, at para. 207.

87. The combined book value of the RBOCs on December 31, 1984, was $51.6-billion. The total market capitalization was $53.7-billion.

earnings opportunities, enabling them to generate significant additional profits far in excess of what would be permissible under the traditional "competitive price" standard of public utility regulation.[88] Not surprisingly, their market-to-book ratios soared. These new opportunities fell into several categories:

- The RBOCs have been allowed, with respect to a number of services and lines of business, to shift the activity *out of regulation* and hence outside of any regulatory earnings constraint. And, although the *rationale* for these deregulatory moves was the asserted onset of "competition" in the particular service or business segment, the RBOCs in fact had and were able to maintain and to exploit their legacy market power in those services so as to generate supracompetitive profits on a continuing basis.

- The RBOCs were granted valuable public resources — electromagnetic spectrum and the use of public rights-of-way — without any payment to the government and with the right to exploit such gifted assets without any price regulation or earnings constraints.

- The RBOCs have been permitted to exploit legacy monopoly relationships with customers and other legacy assets to develop and expand into new nonregulated lines of business, without any obligation to compensate the regulated portion of their operations for the fair market value of those assets.

- The RBOCs have been allowed a number of regulatory concessions that have worked to weaken and ultimately to erode traditional constraints on earnings, premised upon the erroneous notion that the nominal elimination of legal barriers to competitive entry was sufficient to constrain the incumbents' ability to maintain supracompetitive prices and earnings levels.

- The RBOCs have been largely insulated from any serious competitive losses through a variety of funding mechanisms that have shifted the preexisting sources of excess profit into fees and other charges that are imposed upon competitors and, ultimately, consumers, serving not only to make the RBOCs whole with respect to any actual competitive "losses" they may sustain, but concurrently to increase competitors' costs and make their entry and success all the more difficult.

The ten specific *Bellfare* programs whose value is quantified here thus account for a substantial portion of the $264-billion in premium value of RBOC stock. It is far less clear, however, that any valid public purpose is served by maintaining any of these giveaways, especially when doing so will fundamentally undermine efforts to achieve a truly sustainable competitive telecommunications market.

88. See footnote 9, *supra* at 145.

Conclusion: *Bellfare* supports and sustains persistent RBOC anticompetitive conduct

Before the ink had a chance to dry on the 1984 divestiture decree, the RBOCs commenced efforts aimed both at extricating from economic regulation a succession of their historically regulated business activities, and at gaining reentry into various lines of business from which they were explicitly barred. In virtually all of these cases — yellow pages, information services, long distance services, special access and, most recently, broadband — RBOCs have advanced the two-pronged claim that (a) the specific market (to be deregulated or in which reentry is sought) had become sufficiently competitive that the RBOC no longer has market power, and (b) that its ability to engage in cross-subsidization and predatory pricing in the putatively competitive market is constrained by the pervasive regulation of its monopoly services. For example, in their Declaration filed in support of SBC's recent petition for non-dominant status with respect to so-called "advanced services,[89] Crandall and Sidak argue that "SBC could not possibly finance a predatory pricing strategy through cross-subsidization [because] SBC's basic local exchange rates are subject to rigorous price regulation, including price ceilings, in each of its states. Thus, SBC has no ability to raise basic local exchange prices to finance below-cost DSL prices. Similarly, SBC's switched access prices are capped ... at 0.55 cents per minute and its special-access rates are constrained by price cap regulation in all areas that do not exhibit sufficient competition to qualify for pricing flexibility."[90] The problem, of course, is that merely "exhibit[ing] sufficient competition to *qualify* for pricing flexibility" is clearly a woefully insufficient test for the presence of *actual* price-constraining competition. Indeed, as noted recently by the Ad Hoc Telecommunications Users Committee, SBC and the other BOCs have *increased their special-access rates* above the price-cap ceiling *in each and all of the markets in which they have qualified for pricing flexibility*.[91] Crandall/Sidak's "impossibility of predation" theory rests upon the patently false notion that RBOC prices and earnings are "capped" at "competitive" or "regulated" levels. But in fact such "caps" apply to only a rapidly shrinking subset of all RBOC services, and the RBOCs' demonstrated ability to generate supracompetitive profits, together with their extensive corporate welfare benefits, work to foster and facilitate such cross-subsidization and predation.

Competition cannot withstand the pervasive and extensive subsidization of dominant incumbents. Nor can it be expected to survive when isolated market segments in which entrants have achieved even the most limited presence are "declared" as competitive by regulatory fiat. The RBOCs clearly do not *need* corporate welfare, but consumers and competitors *do need for it to stop*.

89. *In the Matter of SBC Petition for Expedited Ruling that it is Non-Dominant in the Provision of Advanced Services for Forbearance from Dominant Common Carrier Regulation of Those Services*, Declaration of Robert W. Crandall and J. Gregory Sidak on behalf of SBC Communications, Inc., Filed October 3, 2001, also submitted in *In the Matter of Review of Regulatory Requirements Incumbent LEC Broadband Telecommunications Services*, CC Docket No. 01-33, Comments of SBC Communications Inc., Filed March 1, 2002, Appendix A.

90. *Id.*, at para. 90.

91. *In the Matter of Performance Measurements and Standards for Interstate Special Access Services*, CC Docket No. 01-321, Comments of the Ad Hoc Telecommunications Users Committee, filed January 22, 2002, at Appendix 1.

Appendix 1

State of the CLEC Market

TABLE 1
CLEC Market Capitalization

	September 30, 1999			March 28, 2002			
		In Millions			In Millions		
Company	**stock price**	**Shares out-standing**	**Market Cap**	**stock price**	**Shares out-standing**	**Market Cap**	**% change from 9/30/99 to 10/16/01**
Adelphia	$ 28.00	51.42	$ 1,439.67	$ 0.04	134.50	$ 5.38	-100%
Allegiance	$ 63.00	64.86	$ 4,086.48	$ 3.00	115.20	$ 345.60	-92%
AT&T Corp	$ 47.44	3,195.63	$ 151,592.86	$ 15.70	3540.00	$ 55,578.00	-63%
Commonwealth Tele	$ 44.00	22.11	$ 972.77	$ 38.25	23.50	$ 898.88	-8%
Connectiv	$ 19.63	87.27	$ 1,712.58	$ 24.89	88.70	$ 2,207.74	29%
CoreCom	$ 37.19	72.05	$ 2,679.43	$ 0.10	98.40	$ 9.84	-100%
CTC Communications	$ 16.44	14.55	$ 239.24	$ 2.55	27.10	$ 69.11	-71%
CTCI	$ 47.00	19.93	$ 936.49	$ 14.90	18.80	$ 280.12	-70%
Intermedia	$ 25.00	50.99	$ 1,274.64	**	**	**	
Focal	$ 23.94	60.65	$ 1,451.72	$ 4.27	171.30	$ 731.45	-50%
Global Crossing	$ 26.50	794.77	$ 21,061.42	$ 0.10	888.60	$ 88.86	-100%
GST Telecomm Inc	$ 7.03	37.71	$ 265.18	**	**	**	
Northpoint	$ 24.31	125.24	$ 3,044.88	**	**	**	
ICG Communications	$ 15.56	47.34	$ 736.77	**	**	**	
Level 3 Communications	$ 52.22	341.08	$ 17,810.58	$ 3.56	392.70	$ 1,398.01	-92%
Worldcom	$ 76.88	1,880.22	$ 144,541.84	$ 6.74	2960.00	$ 19,950.40	-86%
RCN	$ 49.69	76.18	$ 3,785.42	$ 1.41	97.30	$ 137.19	-96%
Sprint	$ 54.25	785.21	$ 42,597.39	$ 15.29	976.00	$ 14,923.04	-65%
Time Warner	$ 21.38	81.25	$ 1,736.72	$ 6.08	114.70	$ 697.38	-60%
Winstar Comm Inc	$ 39.06	54.93	$ 2,145.89	**	**	**	
XO Comm/Nextel	$ 61.38	315.45	$ 19,360.84	$ 0.08	434.80	$ 34.78	-100%
Total CLEC			404111.97			97321.00	-76%

Source: carrier 10Q reports, www.thedigest.com/stocks/

TABLE 2
RBOC Market Capitalization

	September 30, 1999			March 28, 2002			
		In Millions			In Millions		
Company	**stock price**	**Shares out-standing**	**Market Cap**	**stock price**	**Shares out-standing**	**Market Cap**	**% change from 9/30/99 to 10/16/01**
BellSouth	$ 43.25	1885.0	$ 81,526.3	$ 36.86	1,880	$ 69,296.80	-15%
Ameritech	$ 67.88	1177.0	$ 79,888.9				
SBC	$ 52.00	1967.0	$ 102,284.0				
SBC post merger	-	3144.0	$ 182,172.9	$ 37.44	3,350	$ 125,424.00	-31%
Bell Atlantic	$ 69.50	1552.8	$ 107,918.6				
GTE	$ 77.75	1002.2	$ 77,921.1				
Verizon	-	2555.0	$ 185,839.7	$ 46.10	2,720	$ 125,392.00	-33%
US West	$ 59.19	485.0	$ 28,703.2				
Qwest	$ 36.47	747.0	$ 27,242.2				
Qwest post merger	-	1232.0	$ 55,945.3	$ 8.22	1,660	$ 13,645.20	-76%
Total RBOC			$ 505,484.2			$ 333,758.0	-34%

Note: US West 9/30/99 shares outstanding represents last reported shares outstanding of US West in April 1998
Source: Daily Stock Price Record, NYSE, Oct.-Dec. 1999, Standard & Poor's 2000, carriers 10Q reports

Appendix 2

Alternate Top-down Analysis

Appendix 2

Alternate Top-down Analysis

An additional basis for corroborating the aggregate value of the individual *Bellfare* programs calculated in this paper is accomplished by comparing RBOC revenues derived annually from regulated switched local exchange and access services with the economic costs that the RBOCs incur to provide these services. This includes both the costs of the RBOCs' local networks plus the retailing costs (e.g., marketing and other overheads) that they incur to provide these services to carriers and end-user customers. The difference between the revenues the RBOCs receive from selling these services and the economic costs (which includes a normal profit) they incur to provide these services represents their excess or monopoly profit. However, note that because the RBOCs may also earn monopoly profits from their provision of nonregulated and/or non-switched services (e.g., cellular service, Yellow Pages, billing and collection, private lines, etc.), the calculation presented here will not capture all of the excess profits that regulators and the government may have permitted the RBOCs to arrogate. But by limiting the analysis strictly to regulated switched services, we are able to focus specifically upon the excess profits that the RBOCs have been allowed to acquire from the very activities that (in principle) government regulators most assiduously attempt to protect from being priced at above-cost, monopoly levels.

Table 2

Conservative Estimate of the Value of Corporate Welfare ("Bellfare") Programs Granted to the Regional Bells

"Tops-down" analysis

Method	**Annual value**	**Capitalized value**
Excess switched services profits assuming retail costs given by TSR discount	$30,868,524,136	$179,901,820,421
Excess switched services profits assuming retail costs given by ARMIS	$28,766,449,959	$167,650,927,909

Quantification: RBOC switched revenues for 2000 are collected from FCC ARMIS 43-03 Reports, Table I.[92] Switched access lines for 2000 are collected from FCC ARMIS 43-08 reports, Table III, column dj.

The cost of the RBOCs' network platform is derived from the FCC's Synthesis Model for universal service, adjusted to yield total switched local network element costs. This adjusted model estimates the TELRIC of providing all local telephone and switched access services. It includes a return on invested capital and an allowance for general overhead costs.[93]

Retailing expenses are calculated via two different methodologies. The first is to use the wholesale discount that an RBOC applies to its retail rates when its local services are resold by CLECs to end-users.[94] The second methodology is to use the RBOCs' reported embedded retail costs.[95] The present value of excess profits are then calculated as a ten year annuity using an annual discount of 11.25%, the RBOCs' most recent FCC-authorized rate of return.[96]

Annual Value: $30.87-billion (TSR discount basis) or $28.77-billion (embedded ARMIS basis)

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92. These revenues are the sum of lines 5001, 5002, 5060, 5069, 5081, 5082, 5084, and 5100 (see http://gullfoss2.fcc.gov/cgi-bin/websql/prod/ccb/armis1/forms/armis.hts for source data). This figure may overstate slightly switched revenues because State Access (line 5084) includes some small amount of special access. The effect of this overstatement will be immaterial to the results. Furthermore, because SNET and GTE are excluded from the revenue and cost data collected for this analysis, its computation of excess profits will be an underestimate of total RBOC excess profit.

93. *Fifth Report and Order*, *In the Matter of Federal-Joint Board on Universal Service* (CC-Docket No. 96-45) *and Forward Looking Mechanism for High Cost Support for Non-Rural LECs* (CC-Docket No. 97-160), Before the Federal Communications Commission, October 28, 1998 and *Tenth Report and Order*, *In the Matter of Federal-Joint Board on Universal Service* (CC-Docket No. 96-45) and *Forward Looking Mechanism for High Cost Support for Non-Rural LECs* (CC-Docket No. 97-160), Before the Federal Communications Commission, November 2, 1999. The universal service version of the Synthesis Model may be obtained from the FCC's website at http://www. fcc.gov/ccb/apd/hcpm/). The indicated adjustments made to the model to include costs for providing intraLATA toll and access services are explained in *Ex Parte Presentation by AT&T to Federal Communications Commission*, *In the Matter of Application by Verizon New England, Inc. Bell Atlantic Communications, NYNEX Long Distance Company, and Verizon Global Networks to Provide In-Region InterLATA Services in Massachusetts*, CC Docket No. 01-9, February 1, 2001.

94. These are collected from *Tele*FOCUS Special Industry Report, 8/11/00.

95. These are collected from RBOC year 2000 ARMIS 43-03 Reports, Table I, column i, for direct retail accounts (6610, Marketing, and 6620, Service Support) plus retail share of overhead accounts (6120, General Support, 6710, Executive and Planning, and 6720, General and Administrative). The latter are computed by applying the direct retail share of operating expenses, excluding overhead accounts, depreciation and access expenses to these overhead accounts.

96. See *Tenth Report and Order*, *In the Matter of Federal-Joint Board on Universal Service* (CC-Docket No. 96-45) and *Forward Looking Mechanism for High Cost Support for Non-Rural LECs* (CC-Docket No. 97-160), Before the Federal Communications Commission, November 2, 1999. Note again, that this top-down calculation examines only the excess monopoly profits the RBOCs are able to extract from their regulated switched services business. Because the RBOCs have a substantial stable of unregulated businesses such as cellular, Yellow Pages, etc. that derive benefit from being provided by the local monopoly telephone company; and because they also earn excess profits on their non-switched telecommunications business, this top-down estimate must understate severely the RBOCs total regulatory grant of excess profits.

Capitalized Value: $179.90-billion (TSR discount basis) or $167.65-billion (embedded ARMIS-basis)

The results of these calculations are presented on the following table.

Calculation of Monopoly Profits Embedded in RBOC Prices for Switched Local and Access Service

	Verizon (w/o GTE)	SBC (w/o SNET)	BellSouth	Qwest (aka U S West)	Total RBOC (VZ SBC BLS Q)
Revenue					
Total switched local and toll revenues	$14,199,254,000	$20,024,377,00	$10,199,781,00	$6,127,731,000	$50,551,143,000
Total switched access revenues	$5,779,936,000	$7,259,303,000	$3,631,255,000	$2,861,058,000	$19,531,552,000
Total switched revenue per year	$19,979,190,000	$27,283,680,00	$13,831,036,00	$8,988,789,000	$70,082,695,000
Switched access lines					
Revenue per line per year	$465.31	$490.79	$571.40	$509.97	$499.30
Revenue per line per month	$38.78	$40.90	$47.62	$42.50	$41.61
Economic Costs (line/month)					
Cost of network platform (incl. return)	$16.79	$16.25	$22.00	$18.66	$17.71
Retail costs based on TSR discount	$5.34	$5.61	$6.35	$4.94	$5.57
Total switched economic cost (TSR	*$22.13*	*$21.86*	*$28.35*	*$23.60*	*$23.28*
Cost of network platform (incl. return)	$16.79	$16.25	$22.00	$18.66	$17.71
ARMIS switched retail costs	$5.58	$7.52	$6.55	$8.00	$6.82
Total switched economic costs	*$22.37*	*$23.77*	*$28.55*	*$26.66*	*$24.53*
Monopoly Profit (assuming retail costs are given by TSR discount)					
Excess profit per line per month	$16.64	$19.04	$19.27	$18.90	**$18.33**
Total excess profit per year	$8,575,064,368	$12,699,842,44	$5,596,278,396	$3,997,338,930	**$30,868,524,136**
PV of 10 years of this profit	$49,975,492,290	$74,014,707,16	$32,615,121,68	$23,296,499,28	**$179,901,820,42**
Monopoly Profit (assuming retail costs are given by					
Excess profit per line per month	$16.40	$17.13	$19.07	$15.84	**$17.08**
Total excess profit per year	$8,451,586,627	$11,427,446,73	$5,537,898,819	$3,349,517,782	**$28,766,449,959**
PV of 10 years of this profit	$49,255,863,770	$66,599,182,40	$32,274,885,39	$19,520,996,33	$167,650,927,90

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