

**COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

**Investigation by the Department of Telecommunications and Energy)
on its own Motion into the Appropriate Regulatory Plan to succeed)
Price Cap Regulation for Verizon New England, Inc. d/b/a Verizon)
Massachusetts' intrastate retail telecommunications services in the)
Commonwealth of Massachusetts)**

D.T.E. 01-31

INITIAL BRIEF OF THE ATTORNEY GENERAL

REDACTED VERSION FOR THE PUBLIC RECORD

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¹ Verizon New England d/b/a Verizon Massachusetts, was formed from New England Telephone and Telegraph Company (“NET”), one of the 22 local Bell companies operating under the AT&T (“Ma Bell”) umbrella. In 1984, AT&T was broken up into seven regional Bell operating companies and NET combined with New York Telephone to become NYNEX. NYNEX merged with Bell Atlantic in 1997 and became known as Bell Atlantic, and Bell Atlantic merged with the GTE Corporation on June 30, 2000 to form Verizon.

the pending PAP audit in an open and transparent manner to assure that the Massachusetts local market remains open to competition.

II. STATEMENT OF THE CASE

On February 27, 2001, the Department opened its investigation into an appropriate regulatory plan to replace the Department's Price Cap Plan established under NYNEX, DPU 94-50 (1995), which expired August 15, 2001. Vote and Order to Open Investigation (February 27, 2001). On April 12, 2001, Verizon filed its proposed Alternative Regulation Plan ("Verizon Plan")² and supporting testimony. The Department held four public hearings on the Verizon Plan, conducted procedural conferences, and on June 21, 2001, issued its Scoping Order which bisected the investigation.

According to the Scoping Order, the Department will investigate in Phase I, "whether or not there is sufficient competition in Massachusetts to warrant: 1) a classification of 'sufficiently competitive' for the services for which Verizon proposes full market-based pricing flexibility or revenue-neutral price changes; and 2) a departure from traditional cost-of-service or indexed price cap regulation for the remaining services." Scoping Order at 18-19. The scope of Phase II of this investigation, to begin upon completion of Phase I, will depend on the Department's finding of "sufficiency of competition."³

² The Verizon Plan was attached as part of Ms. Paula Brown's direct testimony filed April 12, 2001.

³ According to the Department, "If Verizon meets its burden of proof to show that the services for which it seeks pricing flexibility are sufficiently competitive and that competition is sufficient to warrant the use of an alternative form of regulation for other services, the second phase will consist of an investigation into whether Verizon's proposed plan, or later-filed intervenors' plans, for regulatory treatment of those services is appropriate. If Verizon has not

(continued...)

The Attorney General and several carriers intervened in the proceeding,⁴ and the parties and the Department issued discovery on Phase I of the investigation. The Attorney General, AT&T, Allegiance Telecom of Massachusetts and Network Plus, Inc. filed rebuttal and surrebuttal testimony.⁵ On December 13, 2001, the Department asked the parties to present additional testimony at the hearings regarding the effectiveness of Verizon's PAP and the ability of competitors to rely on the PAP to prevent anticompetitive pricing by Verizon:

[W]e do not have sufficient testimony as to the effect that the above-described cycle of events has on competition. In other words, if one assumes that any current or future provisioning problems follow a cycle of “non-compliance ? investigation/penalty ? correction” as we do in this Interlocutory Order, then what is the effect on competition of a market structure that relies on this corrective mechanism? That is the issue upon which we seek further testimony – not evidence of provisioning compliance or non-compliance. The testimony we seek will be oral and received during the upcoming evidentiary hearings.

Interlocutory Order on Verizon's Motion to Strike, or in the Alternative, to Supplement Surrebuttal (December 13, 2001) at 5-6.

³(...continued)

met its burden in the first phase, the second phase will consist of an investigation into which form of regulation, be it a continuation of price cap, a restoration of rate-of-return regulation, or some alternative, is appropriate for the level of competition demonstrated by our investigation in Phase I. At the start of the second phase, the Department will address whether the additional categories that intervenors have argued should be included in the scope of this proceeding (e.g., universal service funding, price floors, access reform, a full rate case or earnings review, etc.) will be part of the second phase.” Scoping Order at 17-18.

⁴ The Department granted full intervenor status to Allegiance Telecom of Massachusetts, Inc., AT&T Communications of New England, Inc. (“AT&T”), Global NAPs, Inc., Network Plus, Inc. (“Network Plus”), New England Cable Television Association, New England Public Communications Council, Inc., Sprint Communications Company, L.P., The Association of Communications Enterprises, Qwest Communications Corporation, and WorldCom, Inc., and limited participant status to Boston Gas Company d/b/a Keyspan Energy Delivery New England.

⁵ Allegiance Telecom subsequently withdrew from the case.

The Department conducted evidentiary hearings at its Boston offices on December 17, 19, 20, 2001 and January 3, 2002, during which the Attorney General, Verizon, AT&T, and Network Plus sponsored witnesses. Dr. Lee L. Selwyn of ETI testified on behalf of the Attorney General; John Conroy, Dr. William E. Taylor, and Michael Doane testified for Verizon; Dr. August Ankum testified for Network Plus; and Dr. John May, Deborah Waldbaum, and Anthony Fea testified for AT&T. Paula Brown's testimony was withdrawn, but the Verizon Plan, which was attached to Ms. Brown's testimony, was admitted into evidence as Exhibit AG-21. According to Verizon's Counsel, Ms. Brown's testimony will be considered in Phase II of this investigation. Tr. 1, at 8-9. Robert Mudge's direct testimony was adopted at hearings by John Conroy.

III. STANDARD OF REVIEW

A. Evaluating Local Competition

Verizon must satisfy the Department's statutory mandate of "just and reasonable" telephone rates in any petition it files for a new regulatory proposal. Scoping Order at 15. A proposal must also meet the "Department's telecommunications public policy goals of economic efficiency, fairness, universal service, simplicity, earnings stability and continuity." *Id.* at 15-16. The Department has stated that "regulation serves as a surrogate for market forces in markets not characterized by effective competition." *AT&T of New England*, D.P.U. 91-79, p. 41 (1992) ("AT&T Alt. Reg. Order").

If an entire service class is "fully competitive," then the Department may also determine whether the "prices set by the market are fair and reasonable." *IntraLATA Competition Order*, D.P.U. 1731, p. 39 (1985). Defining whether a market is "sufficiently competitive" is essentially

identical to determining whether any firm operating within that market possesses market power.⁶

Thus, as Dr. Selwyn notes, if Verizon possesses no market power, then the market will appropriately set just and reasonable rates, and the market would be considered “sufficiently competitive.” Exh. AG-1 at 6.

Verizon proposes to eliminate the regulatory constraints on retail prices that existed under the current Price Cap Plan. In the absence of regulatory control, consumer protection rests on the strength of competition. In areas where competition is weak, Verizon has incentive to increase rates selectively to compensate for lowering prices where competition is strong. The Department, therefore, must examine not only whether there is competition in Massachusetts for all services in all wire centers, but also must evaluate the strength and economic viability of that competition. Tr. 1, at 18.

The Department examines three factors to determine sufficient competition in local Massachusetts telephone markets: 1) market share, 2) supply elasticity, and 3) demand elasticity. *AT&T Alt. Reg. Order* at 32-34. Market share has been measured by comparing the number of access lines served at a statewide level and at a wire center level. Exh. AG-1 at 8, Exh. AG-16A, RR DTE-VZ-2. Supply elasticity refers to “the extent to which firms are able to expand or contract their output in response to market price and other market conditions.” Exh. AG-1 at 8. Demand elasticity has been described as a customer’s willingness and/or ability to modify the quantity of a good or service purchased from a given firm in response to a change in that firm’s

⁶ A firm with market power is recognized as having the ability to raise prices above marginal cost without experiencing a decrease in revenue. Exh. AG-1 at 6; Exh. ATT-1 at 20. Stated another way, a firm with market power “has the ability to raise the price of its product or service, and to sustain this price increase over a period of time, without losing so many sales that the price increase is not profitable.” *AT&T Alt. Reg. Order* at 31, fn. 19.

price. *Id.*

1. Market share is an indicator of market power

The Department said it will evaluate market power based on market share, supply elasticity, and demand elasticity. *Scoping Order* at 18. Granting pricing flexibility to a dominant firm like Verizon, if it possess market power, can create the danger of “cross-subsidization” of costs, resulting in economic inefficiencies and inadequate pricing signals. Tr. 1, at 106-107. Dr. Ankum, under examination by the Attorney General, clarified this danger:

[T]here are three strategies that Verizon can employ: It can increase prices; it can lower prices; and most dangerously, it can do both. Presumably what Verizon will do, unless it's controlled, will be to increase prices there where there's very little competition, and to lower prices there where it is losing market share. Well, obviously, when you lower prices where you're losing market share -- and let's say that you do that below cost -- well, that's a drain on the bottom line. You have to make that up somewhere else. Well, you make that up exactly there where there is no competition, where you're increasing your prices. And that is a cross-subsidy, from noncompetitive areas -- I don't want to say services -- that is, from regions where there is no competition to regions where there is competition.”

Tr. 1, at 38-39.

The higher the market share a company holds, the greater control the company holds over market prices. Exh. ATT-1, at 22. As a company's market share declines, the company's ability to control prices also declines. *Id.* Market share is the strongest indicator of the degree of a firm's dominance over the market. *AT&T Communications*, D.P.U. 90-133, Order (January 2, 1991) at 37. High market share coupled with low supply elasticity and low demand elasticity will demonstrate the existence of market power. Tr. 1, at 44-45.

2. Supply elasticity is the second indicator

Supply elasticity, as explained by Dr. Selwyn, refers to “the extent to which firms are able

to expand or contract their output in response to market price and other market conditions.”

Exh. AG-1 at 8. He further explains that:

[I]f firms are able to rapidly adjust their supply — and particularly to increase it — in response to a price change, this will tend to limit any one firm’s ability to maintain supracompetitive prices, thereby limiting or eliminating that firm’s market power. On the other hand, if competitors are not able to expand supply when another firm in the market increases prices, the firm imposing the price increase will have the ability to maintain excessive prices over an extended period of time, which would demonstrate its market power.

Id.

An inability of “fringe” competitors to enter and expand in a market, and the existence of barriers to entry into the relevant market, are additional indicators of supply elasticity. Exh.

ATT-1, at 24. Where the competitors’ ability to enter and expand into a market is low, the incumbent’s dominance approaches market power and the market’s elasticity of supply is low.

Id. Vertically-integrated incumbent firms like Verizon (*i.e.*, firms that control the upstream inputs [wholesale services] that competitors must use to compete) are able to control the market by denying competitors access to the necessary wholesale service inputs and manipulating the price of the wholesale service inputs. *Id.* at 25.

3. Demand elasticity is the third indicator

Demand elasticity has been described as:

[A] customer’s willingness and/or ability to modify the quantity of a good or service purchased from a given firm in response to a change in that firm’s price. In a competitive market where rival firms offer similar, and hence substitutable products, an attempt by any one firm to increase its price will incent customers to switch to an alternative supplier, and the price-raising firm will lose business. On the other hand, if there are no close substitutes *and* the good or service is viewed by the customer as *essential* (such as a core telephone or other public utility service), customers will continue to purchase roughly the same quantity of the product despite the increased price.”

Exh. AG-1, at 8-9. Where market demand is low or inelastic (*i.e.*, consumers consider the service essential), the incumbent firm will hold greater market power. Exh. ATT-1, at 24.

Using these three indicators of market power – market share, supply elasticity, and demand elasticity – Verizon bears the full burden to prove, by substantial evidence, that the local residential and business telephone markets exhibit sufficiently robust competition to support a departure from more traditional forms of price regulation. *Scoping Order* at 17.

B. Defining the Relevant Markets

Before conducting the competitive market analysis, the Department must first determine the exact markets under review. *Id.* at 31. This proceeding addresses two different categories of Massachusetts markets: business and residential. These markets contain customers who have different service requirements, have different costs, and are often serviced by different suppliers. The level of competition in each market is different since each has its own market share, supply elasticity, and demand elasticity. Therefore, the Department should conduct separate reviews of the business and residential markets under the three-pronged sufficient competition test – *i.e.*, whether there is sufficient actual competition in each relevant market such that competitors will exert enough pricing pressures to create just and reasonable prices for consumers.

C. The DTE Should Not Use the Section 271 Standard of “Open to Competition” to Determine Whether There is “Sufficient Competition”

The DTE should not adopt Verizon’s proposal to use, in this proceeding, the same standard of review used to determine whether the local market was open to competition in the context of the Verizon Section 271 standard. The Section 271 standard is not the appropriate standard to determine whether there is sufficient competition in the local market to obviate

pricing regulation. The questions underlying a Section 271 evaluation and a “sufficient competition” standard are “so fundamentally different that the standards should be different.” Tr. 1, at 47-49 (Ankum testimony). A market open to competition is not necessarily a market in which competition actually exists, or in which sufficient competition exists to replace regulatory constraints. As the Missouri Public Service Commission, in reviewing its incumbent local exchange carrier’s (“ILEC”) petition for retail pricing flexibility, recently decided that it would be inappropriate to use the Section 271 standard as a basis for evaluating whether sufficient competition existed to allow the ILEC (Southwestern Bell Communications) its requested pricing flexibility. See Missouri Public Service Commission, *Southwestern Bell Communications*, Case No. TO-2001-467, Order at 17 (December 27, 2001).⁷

The Department, therefore, should impose the significantly higher “sufficient competition” threshold to prevent Verizon from using anticompetitive pricing mechanisms that will curtail competition. The opportunity to compete, which is the Section 271 standard, is not a guarantee of the existence of effective competition. Exh. ATT-2, at 3. Even where a market may be irreversibly open to competition, that market may not have effective competition. Exh. ATT-2, at 10, fn. 7, *citing* U.S. Department of Justice expert Professor Marius Schwartz.

IV. ARGUMENT

The record in this case clearly demonstrates that there is neither “sufficient competition”

⁷ “The Commission’s decision in Case No. TO-99-227, is also relevant to the analysis of the existing regulatory barriers to entry. The Commission determined in that case, that Southwestern Bell had complied with Section 271 of the federal Telecommunications Act of 1996, and that Southwestern Bell’s local markets were open to competition. This finding is not equivalent, however, to a finding that effective competition exists. Southwestern Bell’s own witnesses agreed with this conclusion.” Missouri Public Service Commission, *Southwestern Bell Communications*, Case No. TO-2001-467, Order at 17 (December 27, 2001).

in either the residential or business markets to allow the Company pricing flexibility, nor “sufficient competition” in either market to allow the Department to depart from a cost of service or indexed price regulation. All indicators lead to the conclusion that Verizon holds enough market power to withstand competitive retail pricing pressures. Verizon still retains the lion’s share of the local and toll service in both the residential and the business markets. Supply elasticity in both of the Verizon retail markets is very inelastic. The demand for telecommunication services is also very inelastic. Thus, granting Verizon pricing flexibility for services in either the residential or the business local market is not warranted at this time.

A. Verizon Still Holds The Vast Majority of the Local Market Share

Verizon retains nearly 80% of the combined local residential and business market share, 91.7% of the total residential market and 62.3% of the total business market.⁸ These market share figures indicate a troubling ability on Verizon’s part to raise prices free from competitive checks.⁹ While an 80% - 90% market share alone may not suffice to prove that Verizon holds enough market power to raise prices over a sustained period without experiencing a significant drop in revenues, this figure, when combined with the other factors that measure market power (supply elasticity and demand elasticity), demonstrates that Verizon clearly can withstand

⁸ Exh. AG-23, RR DTE-VZ-2. Verizon’s statewide calculation of market share for business services appears to be heavily weighted by the large number of business lines located in the four Boston wire centers that comprise the Metropolitan density zone – Back Bay, Bowdoin, Franklin Street, and Harrison Avenue. *See also* Exh. RR AG-VZ-1, *Verizon’s UNE investigation*, D.T.E. 01-20 (Part A). By contrast, Verizon holds more than 60% of the business market share in <<PROPRIETARY >> of the 273 wire centers in Massachusetts, which is more than <<PROPRIETARY >>% of the total number of wire centers.

⁹ Verizon agrees that market share is an index of the ability to raise prices. *See* Tr. 2, at 334-335 (Doane testimony).

competitive pricing pressures in the local market and must not be given retail pricing flexibility.

1. The Massachusetts Competitive Profile shows low local market competition activity in nearly all wire centers across the state in both the business and the residential sectors

Verizon provided testimony that showed CLECs have achieved nearly a 20% statewide market share, which means that Verizon's market share for the combined business and residential local market in Massachusetts is 80%. Exh. VZ-1 at 17; Tr. 4, at 459. Following repeated challenges by the Attorney General to the propriety of using statewide averages, Verizon provided the local market shares for business and residential services by wire center. Exh. VZ-3A. Verizon's dominance in the local residential market remains extremely high. Of the 273 wire centers in Massachusetts, Verizon controls more than 90% of the residential market in <<PROPRIETARY >> wire centers, 80-90% of the market in <<PROPRIETARY >> wire centers, 70-80% of the market in <<PROPRIETARY >> wire centers, and 60-70% of the market in <<PROPRIETARY >> wire centers. RR DTE-VZ-2.

On the business side, Verizon controls more than 90% of the business market in <<PROPRIETARY >> wire centers, 80-90% of the market in <<PROPRIETARY >> wire centers, 70-80% of the market in <<PROPRIETARY >> wire centers, and 60-70% of the market in <<PROPRIETARY >> wire centers. *Id.* This testimony, contained in the May 2001 and December 2001 versions of the Massachusetts Competitive Profile (Exh. AG-16A and RR DTE-VZ 2), reveals that Verizon retains a very high presence and competitors have a very low presence in nearly all wire centers across the state in both business and residential markets.¹⁰

¹⁰ As Dr. Selwyn and Ms. Waldbaum noted, the Profile is not a completely accurate indicator of competition because of inaccuracies or inconsistencies contained in the E911

A comparison of the May 2001 version of the Profile with the December 2001 Profile version also shows that UNE competition has decreased significantly during 2001. In the course of its Section 271 application, Verizon filed revised UNE switching prices with the DTE on Friday, October 13, 2000 (allegedly based on New York rates). *Verizon's Section 271 Investigation*, D.T.E. 99-271, Verizon Filing (October 13, 2000). The Department stamp-approved these revised UNE rates without any investigation on the same day as the rates were proposed.

Although Verizon asserted, in a February 15, 2001 *ex parte* communication to the FCC, that the revised UNE rates created a “significant increase” in the amount of competition through this entry mode, UNE-P residential competition has not increased since Verizon changed its rates in October 2000. Verizon, in its FCC 271 filing, stated that there were 8,000 UNE-P residential customers in September 2000 and 9,000 by December 2000. *Application of Verizon (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a/ Verizon Enterprise Solutions) and Verizon (d/b/a Networks, Inc.) For Authorization to Provide In-Region, interLATA Services in Massachusetts*, CC Docket No. 01-9, Verizon Feb. 15, 2001 *ex parte* letter at 5. According to the Verizon Massachusetts Competitive Profile, the number of UNE-P residential customers in Massachusetts increased to <<PROPRIETARY >> as of May 2001, but fell to <<PROPRIETARY >> as of December 2001, a level well below the September 2000 figures. Exh. AG-16A, page 6 of 6; RR DTE-VZ 2, page 6 of 6.

¹⁰(...continued)
reporting data. Exh. AG-1, at 40 et seq.; Tr. 1, at 129-131; Exh. ATT-32; Tr. 4, at 686. Still, the Profile represents a rough approximation of the level of local competition, separates that local market share between business and residential, and distinguishes the source of competition among resale, UNE-P, and facilities-based CLEC competition.

Dr. Ankum's testimony provided a context for gauging the impact of these numbers on competition. Tr. 1, at 53-54, 72. If Verizon's market share for much of the state were reduced to 60%, and if the 40% CLEC market share is full facilities-based (i.e., without dependence on Verizon's facilities), then the Department could consider that the UNE wholesale pricing structure allows competitors the access they need to Verizon's network to compete successfully.¹¹ Such a level of competition from competitors should "keep Verizon honest." Tr. 1, at 54. In another context, the Department, while considering AT&T's request for nondominant status in 1991, rejected AT&T's petition despite its holding a 58% market share in the intraLATA market.¹² Verizon's market share has been reduced to the 60% level, however, in only a very small number of wire centers for business services (<<PROPRIETARY >> out of 273) and far fewer (<<PROPRIETARY >>) for residential services. RR DTE-VZ-2. Clearly, the level of the Company's market shares prevents the Department from permitting Verizon to have pricing flexibility in either the local business market or the local residential market.

2. Verizon has the vast majority of the instate toll service

Although Verizon has not disaggregated its market share information over the instate toll market to the wire center level, it has provided the Department with information on its overall toll market share. The Company's own IntraLATA Presubscription Tracking Reports show that the statewide average of Verizon's instate toll market share ranges between 83.1% and 86.7%

¹¹ *Id.* Dr. Ankum appears to base his estimate of 60% on the U.S. Department of Justice's antitrust merger guidelines.

¹² *AT&T Communications*, D.P.U. 90-133, Order (January 2, 1991) at 2, fn. 2, and at 39; "The evidence clearly shows that AT&T's market share, as measured by the various indicators discussed above, is substantially greater than any single competitor's market share and also is substantially greater than the aggregate market share of all its competitors." *Id.*

from January 2000 to October 31, 2001 (which equates to a 13%-17% CLEC market share).¹³

Verizon has also stated that CLECs serve 20.5% of the residential toll market and 40.0% of the business toll market, for an overall statewide average CLEC market share of 28.8% as of January 2001. Exh. DTE-VZ-2-10. The Company, however, it has not provided any evidence in this docket to show how it calculated any instate toll market share values. Regardless of the measure, all estimations demonstrate that Verizon's control of the toll market is nearly as high as that for local market competition, and cannot be used to support Verizon's assertion of the existence of "sufficient competition" in the toll market.

3. Verizon has too much market share to receive pricing flexibility

The evidence is crystal clear. Verizon has retained a percentage of both the residential and business markets substantial enough to allow it to withstand competitive pressures, whether measured by statewide averages or wire center disaggregation. Although high supply elasticity or demand elasticity in the market could mitigate the impact of this heightened market share figure, that is not the case in Massachusetts. Verizon, contrary to its assertions, has market power and there is not sufficient competition in either the local or the toll residential and business markets to remove the Price Cap regulatory constraints.

B. Supply Elasticity Remains Too Low to Merit Pricing Flexibility

Supply elasticity is the extent to which firms are able to expand or contract their output in response to market price and other market conditions. As Dr. Selwyn testified, there is low supply elasticity for both the residential and business markets in Massachusetts. Tr. 1, at 91.

¹³ Exh. AG-VZ-5-7S (Supplemental). These tracking reports are the best evidence in the record in this case.

Competitors depend heavily on Verizon for wholesale services and any action Verizon takes that limits the competitors' ability to respond to increases in demand will allow Verizon to set supracompetitive prices.

Verizon goes to great lengths to define "actual competition" as the number of companies registered to do business in Massachusetts.¹⁴ A closer look at the evidence, however, shows that the Department should not assign any weight to this testimony regarding potential competition. The record contains information about CLECs who, although listed on the Department's annual report as "registered" to do business, do not actually provide service to any Commonwealth consumers. Some of these firms such as Teligent, WinStar, and essential.com have filed for bankruptcy protection. Some, such as RCN Telecom Services of Massachusetts and BellSouth, did not receive any revenues from Massachusetts operations.¹⁵ Thirty-one CLECs have declared bankruptcy between April and December 2001, and CLECs in bankruptcy tend to scale back operations, drop existing customers, and focus on those assets that can be sold off. Tr. 1, at 24 (Ankum testimony); Exh. NP-1, at 8. The latest casualty is Network Plus, an active party to this docket who will not be participating in the briefing phase of this investigation due to its recent

¹⁴ See, *e.g.*, Tr. 2, at 331-332 ("there are 161 rival firms available to provide service to customers here in Massachusetts"); Tr. 2, at 303-304 (there are 60 CLECs providing services in Massachusetts); Tr. 2, at 338-339; Tr. 3, at 382.

¹⁵ See Exh. AG-17, Exh. AG-20, Exh. AG-1 at 48; Tr. 3, at 365-366. According to the DTE's records, the list of CLECs who filed 2000 Revenue Statements showing no Massachusetts Gross Revenues and who are listed in Exh. AG-12 include: Advanced Telcom of Massachusetts, Inc., American Fiber Network, Inc., Avatar Telecom, Inc., BellSouth, C2C Fiber of Massachusetts, LLC, IDS Telcom, LLC, Line One, LLC, US LEC Communications, Inc., and Williams Local Network, LLC.

Chapter 11 bankruptcy filing.¹⁶

Additionally, not all 60 CLECs listed in the Massachusetts Competitive Profile are competing for the same customers with the same services. Undoubtedly, many of those CLECs are niche players who specialize in small portions of the residential and/or business markets. Verizon asks for pricing flexibility for all services in all wire centers for both residential and business markets based on its bare assertion that it faces 60 competitors. The DTE should not rely on this assertion to grant a blanket pricing flexibility since Verizon is relying on the existence of CLEC tariffs, coupled with questionable E911 data, to support its assertions of competition. Granting pricing flexibility without verifying which competitors are offering which services which residential or business market is dangerous and may seriously retard the development, and jeopardize the survival, of CLEC competition in Massachusetts. Verizon would like the Department to rely on this theoretical competition, the “opportunity to entry” (Tr. 3, at 473), and encourages the Department to “give a tremendous amount of weight to this unverified information.” *Id.* at 482. It is only actual competition, however, not theoretical competition, which will be strong enough to create the market forces on pricing that are necessary to replace governmental regulation.¹⁷

Another measure of supply elasticity is the ability of competitors to raise capital with which to enter markets and expand within markets. Market capitalization is an aspect of market

¹⁶ On February 5, 2002, Network Plus Corp. announced that it has filed a voluntary petition for bankruptcy in Delaware under Chapter 11 of the U.S. Bankruptcy Code. A copy of the Globe news article reporting the bankruptcy is attached as Attachment A.

¹⁷ The same scenario is present in the electric power supply service and the retail gas supply service industries – the vast majority of suppliers provide only to large commercial and industrial customers.

power because it is the ability of the competitor to leverage itself into the market. Tr. 1, at 25.

Witnesses for the Attorney General and Network Plus have clearly shown that the market capitalization rates (*i.e.*, rate of change in the amount of capital amassed by an individual firm) for CLECs and for interexchange carriers (“IXCs”) have dropped dramatically over the past two years when compared with capitalization rates for RBOCs like Verizon. According to Dr. Ankum, market capitalization for CLECs across the country declined 81% and for IXCs declined 73% between December 1999 and December 2001. Exh. AG-1 at 55-57; Exh. NP-1 at 4, 18-24; Exh. NP-2 (updated Table 2.1), Exh. NP-3-7. RBOCs suffered only a 29% decline during the same period. *Id.* Closer to home, Dr. Ankum reported that the decline in market capitalization for 18 CLECs and wholesale providers registered to do business in Massachusetts dropped an average of 95% from December 31, 1999 to December 11, 2001 for a total of over \$40 billion. RR DTE-NP-1; Tr. 1, at 63-67. The six major interexchange carriers experienced a 73% drop, totaling over \$333 billion, over that same period of time. *Id.* Verizon’s response – that the actual number of competitors with substantial capital is irrelevant because there are plenty of competitors who can compete through UNE provisioning since the competitors’ sunk costs are substantially reduced – ignores the economic and financial realities facing CLECs in today’s markets. Tr. 2, at 334. It is obvious that the capital markets are disappearing for the CLECs.

Another indicator of supply elasticity can come through resale competition – that is, competitors who resell all or part of Verizon’s products under their own brand names. Verizon has touted the number of resellers registered to do business in Massachusetts as evidence of strong competition, but the Department should accord that information little weight. Verizon still has the ability to raise and lower its retail prices selectively to cause a price squeeze that will

hinder or eliminate actual competition. Tr. 1, at 30. Resellers have, at best, a minimal impact on the level of competition because the resale rates are tied to Verizon's retail rates and, unlike the situation present in DPU 91-79, Verizon controls the "bottleneck" over wholesale market.¹⁸

Supply elasticity also depends on the service quality a CLEC receives from Verizon when it has access to the Verizon network through resale or UNE prices. Tr. 1, at 91. The imposition of remedial measures on Verizon for poor service quality to competitors, such as through the Verizon Performance Assurance Plan ("PAP") process, is critical to maintain the CLECs' ability to compete and keep the local market door open to competition. Inaccurate reporting of the penalties, insufficient penalties, and delays in delivering penalty payments to CLECs can adversely affect the level of competition. As Dr. Selwyn notes, delays in the PAP cycle will cause competitors to lose business and force customers to go to Verizon instead. Tr. 1, at 92.

The elasticity of supply for telecommunication services in the Commonwealth is very low, or inelastic. Where the incumbent's market share is high and the supply elasticity is low, the only way the incumbent might claim no market power is if the third element, demand elasticity, is high enough to counter the first two elements. As we will see, the final major component of market power, demand elasticity, is low/inelastic, meaning that Verizon's claim that it has no market power must fail.

¹⁸ *AT&T Communications*, D.P.U. 91-79 Order at 33, fn. 20. Verizon reported just 32,000 resold residential lines as of January 2001. Exh. DTE-VZ-2-11, Exh. AG-VZ-2-18. Verizon's current resale (avoided discount) rates are roughly 25% for operator services and 29 1/2% without operator services. Tr. vol. 1 at 55-56. These resale rates are scheduled for review in DTE 01-20 and the Department suspended the resale investigation pending action by the FCC.

C. Demand Elasticity for Telephone Service is Low

Demand elasticity is a customer's willingness and/or ability to modify the quantity of a good or service purchased from a given firm in response to a change in that firm's price. Exh. AG-1, at 8-9. Verizon has failed to demonstrate that the demand elasticity for local or toll telephone services has reached a level where consumers no longer consider the service essential. In fact, Dr. Taylor clearly states, "I don't think Verizon has put a market-demand elasticity on the record, but I think we know for basic exchange services that it's probably pretty low." Tr. 3, at 472. One reason for this low demand elasticity appears to stem from the provisioning problems CLECs experienced when relying on Verizon's unbundled network elements or resale components. Delays in setting up or maintaining service will affect consumers' demand for CLECs' products by reducing the consumers' willingness to change providers in the face of a price increase. Tr. 1, at 45. A consumer who ordered phone service through a CLEC, and whose order was delayed because of provisioning problems between the CLEC and Verizon, is less likely to continue pursuing the order through the CLEC and is more likely to order temporary or permanent service through Verizon.¹⁹ Verizon benefits from its poor provisioning of services and thus the demand elasticity for telephone services remains low. Tr. 1, at 98-99.

¹⁹ See, for example, Dr. Selwyn's testimony regarding his company's attempts to install service through a CLEC. Exh. AG-2. The personal experience of the Attorney General's expert witness, Dr. Selwyn of ETI, in establishing phone service through a Verizon competitor in March - July 2001, provides the Department with an in-depth example of what a customer may have to experience to establish service through a CLEC who relies on Verizon for UNE components. Despite many phone calls, negotiations, and other arrangements, ETI was unable to establish services quickly and eventually set up temporary service through Verizon. Final completion of the service order did not occur until 104 days after the order was placed.

D. Other Factors About Competition the Department Should Consider**1. Verizon's CLEC Report 2001 indicates little actual competition in Massachusetts**

Contrary to Verizon's assertions, its CLEC Report 2001 fails to demonstrate the existence of local competition in Massachusetts. First, the CLEC Report 2001 is based on a critically flawed a survey conducted by the New Paradigm Resources Group of CLECs. The survey results are based on those firms who voluntarily submit responses and is not a mandatory filing. Tr. 2, at 267-268. There is no guarantee of completeness or authenticity. There is no independent verification and no penalties imposed for inaccurate responses in this report. The accuracy of the data, and the conclusions that Verizon has drawn from this data, depend on each CLEC's methods and accuracy in reporting, as well as New Paradigm's interpretations of CLEC responses.

Second, there is very little Massachusetts-specific information contained in the Report. For example, the RCN-specific materials, shown in the proprietary exhibit Exh. AG-15A, show very little, if any, actual CLEC competition activity in Massachusetts. In fact, the information contained in the RCN-specific portion of the CLEC Report 2001 shows only that: (1) RCN has a switch operating somewhere in Boston (Exh. AG-VZ-4-11 and supplements), and (2) (<<PROPRIETARY

>>) Exh. AG-15A. The Department, therefore, should disregard Verizon's assertions that the CLEC Report 2001 demonstrates CLEC activity in Massachusetts.

2. Verizon's comparison of bundled services shows little response to competition

Verizon witness Dr. Taylor testified that there are at least two service offerings from

AT&T Broadband and one from RCN that are priced below a comparable service offering from Verizon. Exh. VZ-2, at 9. According to Dr. Taylor, AT&T Broadband offers a “Digital Right Pak II” at \$20 per month less than the comparable Verizon offering, and a bundled package at \$16 less per month, while RCN offers a comparable bundled package which is \$75 per month cheaper than Verizon’s bundled service offering. *Id.* These prices could result in \$191 - \$900 per year savings over Verizon’s “comparable service packages” and is not an inconsequential amount.

The Company’s analysis fails for two reasons. First, Verizon has failed to make an “apples-to-apples” comparison with AT&T Broadband and RCN bundled service offerings. Verizon has failed to provide any detail as to the calculations, the cable channels and pay stations included in the comparisons, the regional calling plans, or any other proof that Verizon’s bundled service offerings are fairly comparable to offerings by AT&T Broadband or RCN. Second, if the local exchange market is competitive, then Verizon would likely lower prices where effective competition exists. The record does not show, however, that Verizon has made any price reductions in its comparable service packages in response to this allegedly competitive pricing. If these CLECs offer lower prices for comparable services, but only serve about 16 or 17% of the market, it would appear that Verizon has no incentive to respond to the competitive pricing pressure because the market has little effective competition

E. The Department Does Not Have Enough Evidence to Judge the Performance Assurance Plan Because the PAP Audit is Not Complete.

On December 13, 2001, the DTE requested testimony from the parties on the efficacy of the Department’s wholesale non-compliance ? investigation/penalty ? correction cycle, which is

embodied in Verizon's Massachusetts PAP. The Department does not have enough information at this time to judge accurately the effectiveness of Verizon's PAP because the Department has not completed its PAP Audit. Consequently, competitors who rely on Verizon for wholesale or resold services cannot rely on the PAP to detect, deter, and remedy substandard or anticompetitive behavior by Verizon. Furthermore, the Department should disregard Verizon's claims that the PAP Cycle does not impede competition because there is no proof in the record to support this contention.²⁰ The Attorney General provides some guidance on issues to be considered during the Audit and urges the Department to conduct the pending PAP Audit in an open and transparent manner to assure that the Massachusetts local market remains open to competition.

1. The Department just began the PAP Audit and cannot reach any conclusions on the PAP before reviewing the final report

Verizon testified that it had sent a draft Request for Proposal ("RFP") to the Department for review on October 24, 2001, RR AG-VZ-1, and that was all that had been accomplished so far on the PAP audit. Tr. 2, at 288-291. On January 17, 2001, the Department issued a letter order directing Verizon to modify its draft RFP and to file a revised RFP within ten days. *Verizon's Section 271 Investigation*, DTE 99-271, DTE Letter Order (January 17, 2002). On February 5, 2002, Verizon submitted its revised RFP for review, and the Department stamp-approved the revised RFP on February 8, 2002 without seeking input from interested parties. These documents have been filed with the Department as part of D.T.E. 99-271 and set the stage

²⁰ Tr. 2, at 167, 175, and 225. Indeed, Verizon's witness, Dr. Taylor, has never looked at the details of the Massachusetts PAP and admits that he presents no empirical evidence of effectiveness of the PAP, just the FCC's opinion.

for the PAP Audit, which is part of the PAP enforcement cycle described in the Department's December 13, 2001 Interlocutory Order. The Department has not completed the audit, however, so it is not in a position to reach any conclusions regarding the effectiveness of the PAP cycle.

In its January 17, 2002, letter order to Verizon, the Department required the Company to revise its RFP to include additional language to "assure a thorough scope for the PAP's initial audit." *Id.* at 1. The Department required Verizon to increase the number of metrics to be the subject of the PAP's audit. Verizon had proposed six metrics; the Department ordered the Company to use a "statistically valid number of metrics" out of the possible 170 metrics to be identified and justified by the prospective bidders. *Id.* at 2. The Department also required Verizon to increase the auditor's responsibility to examine and verify whether the actual raw data are accurate, and whether Verizon's calculations used to report the metrics accord with the Department's carrier-to-carrier guidelines. *Id.* The Department also required Verizon to change the RFP to reflect that the auditor must independently replicate Verizon's performance for the audited metrics and must verify the accuracy of the bill credits. *Id.* at 3.

In addition to these laudable revisions, the Department should review Verizon's "terms and conditions of this engagement" referenced in paragraph 4 of the RFP to ensure that the terms contained in this 32-page document do not conflict with the Department's orders on the PAP audit. Furthermore, the Department should consider expanding the RFP's scope to encompass all available PAP data, not just one month of data. Verizon has accumulated over a year's worth of PAP compliance data from which to choose, but the RFP will be based on only October 2001 data. Exhs. AG-3 through 9; see also Verizon's PAP compliance filing to DTE 99-271 dated January 25, 2002. Verizon has not demonstrated that this one month's data are typical or

representative for the entire year and has not shown that any variations between this month's data and the remaining available eleven months of data are statistically insignificant.

Verizon has provided ample justification for expanding the evaluation period beyond a single month's worth of data. Based on its "Report of Management" which is part of the February 5, 2002 revised RFP (but not submitted as part of the original RFP), Verizon asserts that the PAP "Evaluation Period" runs from April 1, 2001 through October 31, 2001. Furthermore, Verizon's management contends that the company has complied with the PAP requirements by submitting nine PAP reports dated May 25, 2001 through January 25, 2002. Clearly Verizon intends to use all available data to support its assertions of compliance; surely that same data should be audited to determine the merits of those assertions. The Department should revise the RFP to cover all PAP data available up until the issuance of the RFP, or require Verizon to demonstrate that the one month of selected data are statistically representative of all available data.

2. The PAP Cycle may prove inadequate to promote competition

At hearings, witnesses for the Attorney General, AT&T, and Network Plus testified that the PAP Cycle may not adequately fulfill its intended purpose, in part because the penalties assessed were too small. Dr. Lee Selwyn contended that it is essential that the "magnitude of the penalty should actually exceed the economic benefit to Verizon of the infraction." Tr. 1, at 97. AT&T witness Dr. John Mayo reviewed the total revised monthly penalties for January - October 2001, \$7 million, and Verizon's total operating revenues for calendar year 2000, nearly \$3 billion, and testified that the penalties assessed were "trivial in light of the size of the

Massachusetts market at stake.”²¹

During the initial formation of the PAP, the DTE approved an annual PAP penalty cap of \$147 million. D.T.E. 99-271, Order (September 5, 2001) at 34. This cap, however, is barely 5% of Verizon’s annual total operating revenues for 2000. Exh. AG-11, at 61. Even though the DTE set a PAP limit based on a formula used by the FCC in the New York proceeding, the formula used to determine the amount of penalties is inadequate to deter Verizon from wholesale market noncompliance. The DTE should revise upwards the formula to create a meaningful incentive for compliance.

The preliminary evaluation of the actual PAP penalties assessed are minimal and Verizon may view them simply as a cost of doing business, not as a true incentive to alter its practices toward its wholesale competitors. The Department must, as part of its PAP audit, evaluate this issue again in light of the actual application of its earlier theoretical construct and determine whether the PAP penalties are sufficient to deter anticompetitive behavior. Until the PAP audit is complete, however, the Department will lack sufficient basis from which to draw any conclusions as to the PAP cycle’s effectiveness.

3. The Record does not contain evidence of the effect on CLECs of delays on receiving the bill credits

Although Verizon has supplemented the record with a list of the CLECs who were entitled to receive bill credits or refunds, and the amounts to which those CLECs were entitled and paid, Verizon did not specifically state when those credits were posted. RR AG-VZ-2. Consequently, the record in DTE 01-31 Phase I is void of information regarding the amount of

²¹ See Tr. 4, at 589, 590, 593; Exh. DTE-ATT-2-6; Exh. AG-11 at 61; Tr. 2, at 297-300; Tr. 3, at 439-440.

time that actually passes from the date the bill credit is incurred to the date the CLEC actually receives the credit or payment. Verizon asserts that more than four months may pass from the date of non-compliance to the posting of the bill credits or payment of the penalties, but Verizon has not documented this assertion. Tr. 3, at 453-454.

Two examples where such evidence could be critical in evaluating the PAP's effectiveness are shown through the recent bankruptcy of Network Plus on February 5, 2002 (Attachment A) and AT&T's response to RR AG-ATT 3. According to RR AG-VZ 2, Attachment 1, Verizon owed a substantial amount of money to Network Plus in the form of bill credits (\$<<PROPRIETARY >>). This record request response, however, does not show how long it took Verizon to apply those bill credits, which, together with the events that lead to the creation of the bill credits, may or may not have had an effect on the Chapter 11 filing. AT&T, in its response to RR AG-ATT 3(b), states: "Because the Verizon invoices do not indicate the month for which a PAP credit is given, ATT cannot confirm that TCG has received all PAP bill credits from Verizon to which TCG is entitled under the PAP." Such evidence is necessary to ascertain whether Verizon is delaying payments and the extent to which these delays are harming CLECs and hindering local competition. Consequently, the DTE PAP audit should include a thorough examination of the amount of time from the date the bill credit is incurred until payment of the bill credit, and the effects of that time span on CLECs. Otherwise, any conclusions drawn by the Department without this evidence will be incomplete.

4. The PAP audit must become transparent to ensure reliability

The DTE and interested parties, including the Attorney General, should review critical aspects of the PAP audit, including the RFP bidding process, the selection of the auditor, the

draft and final audit reports, to confirm the accuracy of Verizon's information, data collection and auditing procedures. Verizon has taken an important step in enhancing the openness of the bidding process for the RFP by advising all potential bidders in its RFP that "All responses and related information submitted by you shall be deemed to be submitted to Verizon on a nonproprietary and non-confidential basis, any restrictive notices or legends to the contrary notwithstanding, and shall become the property of Verizon." D.T.E. 99-271, Verizon Massachusetts' Draft Request for Proposal (October 24, 2001 and February 5, 2002), Section 3.4(e), page 6 of 7. This places prospective bidders on notice that all information they submit for the RFP will be publicly available information and not subject to confidential treatment. Allowing the bidding process and the audit process to become transparent will help ensure that the selection of the auditor and the results of the audit are competitive, objective, fair, and accurate.

The FCC recently held that the results of the Verizon-New York Section 272 audit of its separate affiliates must be made public, in order to resolve the apparent reporting discrepancy between Verizon-NY and CompTel, a CLEC that challenged Verizon's ability to hide the results of the audit. *In the Matter of Accounting Safeguards Under the Telecommunications Act of 1996: Section 272(d) Biennial Audit Procedures*, CC Docket No. 96-150, Memorandum Opinion and Order (rel. January 10, 2002). Just as the FCC has done with Verizon's separate affiliates under Section 272, the DTE should make the contents of the Verizon PAP audit report public information and available on the DTE's web site. This will increase the transparency of the audit, enhance the audit's reliability, and increase CLEC willingness to enter and compete in the Massachusetts residential and business markets.

V. CONCLUSION – THE DEPARTMENT SHOULD NOT AWARD PRICING FLEXIBILITY

The Department's investigation has revealed clear evidence that: (1) Verizon still controls a huge share of the local and toll, business and residential markets; (2) the supply elasticity for competitive alternatives (the ability and willingness of competitors to enter the markets and to increase their market shares) is very low; and (3) the demand elasticity for telephone services (the willingness of consumers to change carriers when faced with price changes) is also very low. Verizon's ratepayers have received about \$50 million each year in reduced phone rates over the past six years under the Price Cap Plan, and there is no proof that the proposed replacements for the Price Cap's pricing restraints (*i.e.*, competition, Verizon's Plan, and the PAP enforcement cycle) will give consumers the same level of protection from anticompetitive pricing by Verizon. All this points to the inescapable conclusion that Verizon holds market power in the residential and business local and toll retail markets and will be able to ignore pricing pressures from the few competitors who remain in the local and toll markets.

For these reasons, the Attorney General urges the Department to deny Verizon's petition for pricing flexibility for all residential and business retail services in the local retail market

because there is not sufficient competition to replace the regulatory constraints that existed under the Price Cap Plan, cost-of-service regulation, or other indexed price cap regulation.

Respectfully submitted

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Dated: February 13, 2002

ATTACHMENT A – “NETWORK PLUS FILES CHAP. 11” - Globe Article, 2/6/02

Network Plus files Chap. 11

Funding bid falls through for firm; 650 face job loss

By Peter J. Howe, Globe Staff, 2/6/2002

Network Plus Corp., a Randolph telecommunications service provider for 75,000 small business customers along the East Coast, has filed for bankruptcy protection and plans to lay off 650 of its 1,000 employees this week.

With the shakeout in the telecom sector showing few signs of easing, Network Plus said yesterday it was driven to seek Chapter 11 bankruptcy protection by the refusal of creditors, including FleetBoston Financial, to come through with a crucial \$40 million in funding late last month.

Network Plus is the latest of several would-be Verizon Communications competitors, including locally based Digital Broadband Communications, HarvardNet, and Vitts Networks, to be driven out of business. The once-booming market for competitive phone carriers has imploded and investors have fled the sector, forcing thousands of businesses to scramble and find new service.

Robert Cobuzzi, Network Plus's chief financial officer, said the 11-year-old company plans to auction off its assets within the next three or four weeks. About 600 of its 1,000 employees are based in Massachusetts, although Network Plus would not say how many layoffs will occur here. Cobuzzi also would not identify local customers affected.

Several industry analysts said they were surprised Network Plus had not taken steps to find a buyer before filing for bankruptcy. They predicted that thousands of anxious customers will flee to other providers before any auction is held, sharply reducing the company's value.

"Every day that there's uncertainty about the company, customers start to leave, so the value of the company goes downhill," said Rob Shanahan, chief executive of Conversent Communications, a Marlborough telecom provider that was negotiating last week to buy Network Plus before talks collapsed.

"The real asset there is the customer base, but they could lose half their customers in 30 days. People will panic," said Shanahan, adding that his company had stepped up efforts to begin signing up and connecting former Network Plus customers as it has customers of other failed providers. Conversent counts 27,000 customers in New England, New York, and New Jersey.

Alan Russell, a spokesman for rival CTC Communications of Waltham, said his company has generally focused on bigger customers than the eight- to 20-phone businesses Network Plus targeted, so he doubted CTC would aggressively market to Network Plus customers.

"We tend to work with medium- and larger-sized businesses. They have a lot of smaller-end accounts" that CTC would probably not try to serve, Russell said.

D.T.E. 01-31, Phase I

Verizon Communications spokesman Jack Hoey said his company would not comment on Network Plus's bankruptcy filing "as a matter of policy."

In court papers, Network Plus listed assets of \$433.2 million and debts of \$206.9 million. Among the largest unsecured creditors are Verizon, to which Network Plus owes \$10.4 million, and Lucent Technologies Inc.

Shares of Network Plus, which traded at over \$60 in 2000, dropped 6 cents to 23 cents Monday before the Nasdaq Stock Market halted trading. It never resumed trading yesterday.

In its last quarterly earnings report, Network Plus said it grossed \$224.5 million for the nine months ended Sept. 30, and for the quarter eked out about \$100,000 in positive cash flow, or earnings before interest, taxes, depreciation, and amortization.

However, Cobuzzi said a group of creditors including Fleet, Credit Suisse First Boston, Goldman Sachs, and IBM Credit Corp., froze funding on a \$225 million line of credit Network Plus arranged two years ago, on which he said it had drawn down \$178 million.

"Our feeling was that we would have turned cash-flow positive with that \$47 million," Cobuzzi said, but "the lenders decided they just didn't want to put more money into it."

Peter J. Howe can be reached by e-mail at howe@globe.com.

This story ran on page C3 of the Boston Globe on 2/6/2002.

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**COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Regulatory Plan to succeed Price Cap Regulation for Verizon New England, Inc. d/b/a Verizon Massachusetts' intrastate retail telecommunications services in the Commonwealth of Massachusetts	)))))))	D.T.E. 01-31
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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding by e-mail and either hand-delivery, mail, or fax.

Dated at Boston this 13th day of February 2002.

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