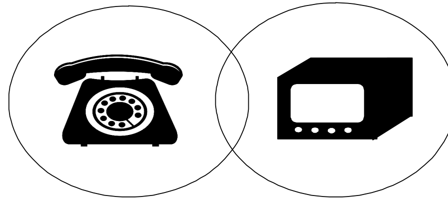
WHITE PAPER

THE CABLE-TELCO DUOPOLY'S DEPLOYMENT OF NEW JERSEY'S INFORMATION INFRASTRUCTURE: ESTABLISHING ACCOUNTABILITY



prepared for the

Public Advocate of New Jersey

Division of Rate Counsel

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PREFACE

The New Jersey Division of Rate Counsel submits this paper to contribute affirmative recommendations to assist the New Jersey Board of Public Utilities in establishing cable franchise regulations that protect consumers of noncompetitive telecommunications and cable services from subsidizing Verizon's and the cable industry's entry into new lines of business.[1] Carefully constructed safeguards will yield just and reasonable rates for basic cable and basic telecommunications services and will also support the continuing evolution of a sophisticated information infrastructure for the state of New Jersey. Also, by deterring improper cross-subsidization, safeguards will contribute to the establishment of accurate pricing signals, and, therefore, to the economically efficient deployment of investment throughout the state by suppliers that compete on an equal footing.

Structural separations, whereby the company's business segments providing noncompetitive services operate separately from those business segments that provide competitive offerings, are critically important in those instances in which the economies of scope are such that firms use substantial amounts of common network plant investment and common resources to support noncompetitive, regulated *and* (purportedly) competitive, unregulated services. The benefit of structural safeguards to today's consumers is that, if implemented and enforced adequately, consumers of regulated services will not subsidize unregulated services. Therefore, rates will be lower than they otherwise would be, and, furthermore, will correspond more accurately with the underlying costs of providing those regulated services. As incumbent local exchange carriers increasingly derive revenues from unregulated services, and as they venture into new lines of business such as FiOS and video services, structural safeguards are increasingly important. Absent adequate safeguards, consumers could end up footing the bill for Verizon's pursuit of video subscribers and its development of other unregulated offerings. Similarly, customers of basic cable services are at risk of subsidizing cable companies' entry into new markets. Structural safeguards are particularly important as a result of the enactment of the recent statewide cable-franchise bill, which streamlines Verizon's entry into New Jersey's cable markets.

Structural safeguards also benefit future consumers. First, they minimize the opportunity for undetected subsidization of unregulated services with revenues derived from regulated services and for carriers' exertion of their market power, and thereby minimize anti-competitive consequences in the market. A competitive market will yield greater diversity in service offerings, lower rates, and higher service quality than would otherwise ensue. Second, if in the future, carriers' attempts to enter new markets prove unprofitable, adequate safeguards will prevent future generations of consumers from footing the bill for business plans gone awry.

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[1]/ The authors, Susan M. Baldwin, Sarah M. Bosley, and Timothy E. Howington, consult to public sector agencies on the economics, policy, and regulation of telecommunications.

EXECUTIVE SUMMARY

The Board's cable regulations should encompass adequate consumer protection against improper cross-subsidization.

Recent legislation has altered dramatically the converging cable-telecommunications ("cable-telco") market in New Jersey by facilitating Verizon New Jersey's entry into cable markets. As directed by the statute, the New Jersey Board of Public Utilities is developing cable television regulations, which will affect consumers throughout the state, and which will guide Verizon New Jersey's and cable companies' entry into each other's traditional markets.

As the telco and cable industry seeks to garner market share in the triple play (voice, data, and video) and quadruple play (triple play plus wireless) bundled services markets, customers of basic telephone and basic cable service are at serious risk of improperly bearing the cost and risk of the industry's forays into new markets. The consequences for basic service consumers are excessive rates and deteriorating service quality.

Telecommunications and cable companies in New Jersey have the ability and the incentive to subsidize their new lines of business with their noncompetitive ones.

Telecommunications and cable companies have the ability and the incentive to subsidize their pursuit of new markets with their noncompetitive operations and services. There is insufficient competition in either cable or telco markets to protect consumers from bearing the cost and risk of companies' entry into non-traditional markets. Verizon New Jersey controls 97% of the local lines in its territory either directly with its retail service or indirectly with its wholesale service. Despite industry-generated hype, intermodal alternatives do not constrain the incumbent carriers in the wireline market.

Cable companies continue to raise rates and although, theoretically, they can compete, in fact, the incumbents continue to serve non-overlapping territories. The semblance of competition in the converging cable and telecommunications industries is misleading. A cable-telco duopoly controls 98 percent of the nation's broadband connections to the Internet, and, therefore, dominates the state's "pipes" over which households and businesses make telephone calls, access the Internet, locate information, conduct business, and obtain entertainment.

Telecommunications and cable companies each rely on substantial shared and common networks, overhead, expertise, and other common resources to offer both traditional and new services to New Jersey consumers. This large amount of joint and common resources facilitates improper cross-subsidization.

Improper cross-subsidization harms consumers.

The New Jersey Telecommunications Act of 1992[2] prohibits the subsidization of competitive services with revenues derived from noncompetitive services. The Legislature stated that "[n]o local exchange telecommunications company may use revenues earned or expenses incurred in conjunction with noncompetitive services to subsidize competitive services."[3] Improper cross-subsidization harms consumers. When cross-subsidization occurs, companies charge excessive rates for regulated, noncompetitive services and divert resources toward new lines of business, jeopardizing the quality of basic services. Also, anticompetitive cross-subsidization thwarts emerging competition, which, in turn, denies consumers the benefit that a sufficiently competitive market would otherwise offer. Finally, improper cross-subsidization yields rates that are not aligned with costs: these inaccurate pricing signals lead to market distortions in the supply of and demand for telecommunications and cable services.

Under today's deregulatory paradigm, where true competition has not yet arrived, but new services are unregulated, consumers are vulnerable to two distinct harms as the incumbent telephone companies roll out new technology: (1) some consumers will be left behind as the telco-cable duopoly races to attract and to lock in high-revenue customers; and (2) precisely those consumers who are left behind will be forced to subsidize new services.

As Verizon moves into new lines of business, including broadband and video markets, it is essential to ensure that basic noncompetitive services are not subsidizing these new services. It is also essential to ensure that Verizon does not neglect the more "mundane" responsibilities of installing and repairing basic telephone service in a timely manner. Verizon's service quality has been declining in New Jersey, as measured by the time required to repair telephone service. Similarly, in New York, where Verizon has also been rolling out its new FiOS, Verizon's service quality has also been deteriorating.

Existing federal and state policies do not protect consumers adequately.

Although federal legislation[4] and state legislation[5] prohibit improper cross-subsidization, adequate safeguards are essential to deter and to detect such cross-subsidization. The Board lacks the necessary tools to ensure compliance and, furthermore, has not yet established the requisite incentives to encourage proper cost accounting. Therefore, the Board should ensure that its final cable regulations require

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[2] / N.J.S.A.: 48:2-21.16 *et seq.* ("1992 New Jersey Act").

[3] / N.J.S.A.: 48:2-21.18.c.

[4] / Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act"), Section 254(k). The 1996 Act amended the Communications Act of 1934. Hereinafter, the Communications Act of 1934, as amended by the 1996 Act, will be referred to as "the 1996 Act," or "the Act," and all citations to the 1996 Act will be to the 1996 Act as it is codified in the United States Code.

[5] / 1992 New Jersey Act.

structural separations, include adequate accounting and non-accounting safeguards, and establish timetables for audits.

The Board should impose structural separations to ensure that the state's information infrastructure evolves in an economically efficient manner.

In a world in which companies increasingly integrate and promote "bundles" of diverse technologies, requirements for accounting and accountability may seem arcane. Indeed, if the product market were competitive, that is, if there were no dominant carriers capable of exerting market power, proposals for accounting and structural separations, and many other regulatory proposals, would be superfluous. However, as this paper demonstrates, a number of the underlying components of the product bundles that Verizon, Cablevision, Comcast, and other cable companies advertise and sell are not yet sufficiently competitive.

Therefore, the Board should require incumbent telecommunications and cable carriers to furnish their regulated services separately from their unregulated ones. Furthermore, the Board should establish the necessary accounting and non-accounting safeguards to protect consumers and competitors from improper cross-subsidization.

Safeguards are entirely compatible with the development of an advanced information infrastructure for New Jersey.

Regulatory safeguards are consistent with New Jersey's pursuit of an advanced information structure. They will further the goal of ensuring that carriers establish rates that correspond with costs, yielding pricing signals that contribute to the economically efficient supply of services throughout the state. Regulatory safeguards will also ensure that, in its FiOS-based pursuit of cable customers, Verizon does not ignore all of the basic telephone service customers who either do not have the FiOS option available to them, or decide not to avail themselves of the new option. The timely installation and repair of plain, copper-based dial tone lines is essential to provide New Jersey's households and businesses with reliable access to emergency services, the economic mainstream, and other elements of the state's societal infrastructure.

Furthermore, as Verizon embarks on its ambitious FiOS network, households and businesses in rural communities may continue to lack access to copper-based DSL. The fact that consumers throughout the state, through their basic telephone rates, have financed a ubiquitous copper network, yet cannot even avail themselves of DSL should cause concern for state policy makers. The potential for unfair and uneven access to the state's information infrastructure warrants review. Some residents and businesses will be able to use FiOS for broadband speeds of 5 Mbps to 30 Mbps while other customers must use dial-up to access the Internet.

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1. INTRODUCTION

1.1. Consumers have a stake in telco-cable market convergence.

Technological innovation and advanced services deployment, which the merging of the historically separated video and telephone markets are yielding, may lead to widespread benefits for consumers throughout New Jersey. As lines between voice, data, and video blur, as cable companies increasingly enter traditional telephone company turf and telecommunications companies increasingly enter traditional cable turf, [6] and as companies design and offer new products and services, consumers are enjoying novel and sophisticated ways to obtain and to deliver information for, among other things, work, entertainment, health, public safety, and education. However, as this paper demonstrates, inadequate competition in the provision of information "pipes" to New Jersey homes and businesses jeopardizes just and reasonable rates for basic telecommunications and basic cable services (as well as for "triple" or "quadruple" play bundles).[7] The lack of broadband and narrowband competition, combined with the substantial sharing of joint and common plant utilized to offer traditional, noncompetitive and new lines of business presents significant opportunities for anti-competitive cross-subsidization.[8]

Therefore, adequate safeguards are essential to protect consumers' interests and to ensure that competition can evolve efficiently and fairly as cable and telecommunications companies offer integrated voice and video services. Preventing improper cross-subsidization will promote efficient deployment of resources by businesses and is compatible with a vision of an advanced information infrastructure for the state of New Jersey.

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[6] / On August 4, 2006, Governor Corzine signed cable franchise legislation A-804/S-192. State of New Jersey Office of the Governor, Press Release, "Governor Corzine Signs Cable Franchise Legislation and Executive Order," August 4, 2006. On November 2, 2006, Verizon filed the first systemwide cable franchise in New Jersey (Verizon New Jersey, Inc. *Application for a Systemwide Cable Franchise*, November 2, 2006, ("Verizon Franchise Application"). The Board approved Verizon's application and granted Verizon a systemwide cable television franchise on December 18th, 2006 (*In the Matter of the Application by Verizon New Jersey, Inc. for a Systemwide Cable Television Franchise*, New Jersey Board of Public Utilities Office of Cable Television Docket No. CE06110768, *Order*, December 18, 2006 ("Verizon Systemwide Cable Television Franchise Order")).

[7] / "Triple play" refers to bundles of voice, data, and video services. "Quadruple play" refers to bundles of voice, data, video, and wireless services.

[8] / Cross-subsidization refers to the use of revenues and resources from one line of business to fund initiatives in another line of business. In this paper, cross-subsidization refers to the use of revenues and resources derived from the traditional, regulated and noncompetitive portions of the carriers' business to fund new, unregulated initiatives.

INTRODUCTION

It is in Verizon New Jersey Inc.'s ("Verizon")[9] and the cable industry's financial interest to attempt to persuade the Board of Public Utilities ("Board") of the myth that regulation will stymie technological advancement, and that by asserting its authority to oversee Verizon's and the cable industry's accounting for its new ventures, the Board will hinder the deployment of an advanced information infrastructure in New Jersey. Regional Bell operating companies ("Bells" or "RBOCs") throughout the country used precisely this line of argument during the 1990s and early 2000s to obtain regulatory freedoms in exchange for unenforceable and rarely fulfilled promises to deploy state-of-the-art technology.[10] A more rational regulatory future will reject any potential infrastructure scare tactics (where carriers threaten to hold hostage new technology if regulators seek to look too closely at their cost accounting and affiliate transactions), and will not barter away consumer protections for phantom promises.

Properly designed regulation will serve as the catalyst for economically efficient pricing signals for both old and new services. In turn, these accurate pricing signals will yield an efficient allocation of society's resources that corresponds with consumers' demand for old and new services. Absent such intervention, marketplace distortions (driven in large part by the industries' incentive and ability to subsidize competitive ventures with their noncompetitive offerings) will result in misleading pricing signals that do not correspond with underlying costs and that, therefore, will not yield the efficient supply of services to consumers and businesses throughout the state. If Verizon and the cable industry truly consider it profitable to enter each other's traditional lines of business, based on fair accounting of the costs to pursue such businesses, these financial incentives should prevail in the presence of regulatory safeguards that ensure that noncompetitive services do not subsidize competitive ones.

Furthermore, as Verizon embarks on its ambitious FiOS network, which is expected to pass half the households it serves nationwide by 2010,[11] households and businesses in rural communities may continue to lack access to copper-based DSL

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9 / This paper refers to Verizon New Jersey, Inc. as Verizon or Verizon NJ. When the discussion includes Verizon New Jersey's parent company, Verizon Communications, Inc., the company is referred to as Verizon Communications.

10 / For example, in 1992, New Jersey Bell's (now Verizon NJ) original petition for an alternative form of regulation indicated that "the plan would enable NJ Bell to invest in the accelerated deployment of advanced switching and transmission technologies for its communications network." *In the Matter of the Application of New Jersey Bell Telephone Company for Approval of Its Plan for an Alternative Form of Regulation*, Docket No. T092030358, May 6, 1993 ("PAR-1 Order"), at 1. The Board approved New Jersey Bell's plan, with modification, "conditioned upon a commitment by NJ Bell to achieve ONJ [Opportunity New Jersey] in its entirety, including full broadband capability by the year 2010." *Id.*, at 97. ONJ remains incomplete and warrants the Board's review.

11 / Thomson StreetEvents, Conference Call Transcript, Verizon FiOS Briefing Session, Sept. 27, 2006 ("Verizon FiOS Briefing Session"), at 4.

service.[12] The fact that consumers throughout the state, through their basic telephone rates, have financed a ubiquitous copper network, yet cannot even avail themselves of DSL should cause concern for state policy makers. The technological leapfrogging of some communities over rural ones will create unfair and uneven access to the state's information infrastructure, which merits Board review. Some residents and businesses will be able to use FiOS for broadband speeds of 5 Mbps to 30 Mbps while other customers must use dial-up to access the Internet.

This paper was prepared on behalf of the New Jersey Division of Rate Counsel ("Rate Counsel"). The Rate Counsel's responsibility is to ensure that all classes of utility consumers receive safe, adequate and proper utility service at affordable rates that are just and nondiscriminatory.[13]

1.2. Purpose of paper.

The purpose of this paper, prepared on behalf of Rate Counsel, is to provide a factual foundation and economic principles to guide the Board's development of policy and regulation to address the telecommunications and cable industries' use of common plant and resources to offer competitive and noncompetitive services. This paper demonstrates that there is insufficient competition in the overlapping telecommunications and cable markets to yield just and reasonable rates and adequate service quality.

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[12] / In New Jersey, 88% percent of residential end-user premises where ILECs offer local telephone service have xDSL availability. Industry Analysis & Technology Division, Wireline Competition Bureau, Federal Communications Commission, *High-Speed Services for Internet Access: Status as of December 31, 2005*, July 2006 (Data as of December 31, 2005) ("FCC High-Speed Services July 2006 Report"), at Table 14. Because rural communities have small populations, they do not comprise a significant percentage of total households in New Jersey, but likely comprise the vast majority of the underserved regions of the state. Verizon's focus on its FiOS operations and away from rural operations is evidenced more recently by its sale of its telephone business in Maine, New Hampshire, and Vermont. "Verizon to Sell Phone Assets to FairPoint in 3 States," *The New York Times,* C4, January 17, 2007.

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

Therefore, regulatory intervention is essential to protect consumers from monopoly practices and cross-subsidization; to enable emerging competition to evolve in telecommunications and cable markets; and to identify those markets which, absent regulatory directives, will not be served adequately because the probable costs exceed the probable revenues.

The Board's regulations should require structural separations, whereby Verizon's venture into FiOS and video lines of business are offered from an affiliate that is separate from its traditional telecommunications business[14] and whereby the cable industry's venture into telecommunications is offered from an affiliate that is separate from its basic cable service offerings. Structural separations are essential to protect today's generation of consumers from improper cross-subsidies. Structural separations are also essential to protect future generations of consumers from footing the bill for any FiOS plans that go awry. If the Board does not impose structural safeguards, it should adopt a comprehensive system of non-structural safeguards.

The Board seeks comment on its proposed cable rules.[15] The purposes of this paper are to contribute to the discussion about those proposed rules and also to offer specific recommendations. The paper's analysis and proposals are intended to encourage the evolution of an advanced information infrastructure in New Jersey that meets consumers' demand, and that is priced in a way that recovers a fair and economically efficient portion of the industry's shared and common costs.

1.3. Organization of paper.

The following chapter, Chapter 2, demonstrates that the cable and telecommunications industries have the ability to engage in improper cross-subsidization. Chapter 2 also analyzes and describes the implications of a duopoly for consumers.

Chapter 3 describes how incumbent cable and telecommunications companies have the incentive to engage in cross-subsidization. Chapter 4 discusses generally the existing federal and state policy vis-à-vis cross-subsidization, and demonstrates that it is not sufficient to protect consumers. Chapter 5 sets forth the Rate Counsel's recommendation, and Chapter 6 concludes the main portion of this paper. Also included with this paper are several appendices which provide detailed data and information pertinent to the issues this paper encompasses.

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[14]/ References are made to Verizon throughout because Verizon is the primary incumbent local exchange provider in New Jersey and it sought and received a systemwide cable franchise. Embarq Corporation, formerly United Telephone Company (the Local Telecommunications Division of Sprint), served approximately 205,441 switched access lines in 2005 as an incumbent in New Jersey. Verizon New Jersey served approximately 5,414,559 switched access lines in 2005. FCC ARMIS Report 43-08, Table II. Switched Access Lines in Service.

[15] / *In the Matter of the Board's Regulations of Cable Television, Proposed Readoption with Amendments and New Rules: N.J.A.C. 14:18-14 and 15,* Verizon BPU Docket Nos. CX06030141 and CX06080580, Proposal Number: PRN 2006-384 ("Proposed Regulations").

1.4. Overview of relevant markets.

This paper focuses on the New Jersey telecommunications ("telco") and cable markets, but also analyzes national market and regulatory trends as well as Verizon and national cable industry corporate-level strategies and practices because they influence New Jersey's market. To the extent available, data specific to New Jersey's market are provided, and these data are supplemented by national data. Although New Jersey is ahead of other states from the perspective of cable franchising, the emergence of a cable-telco duopoly and the convergence of voice, data, video, and wireless is occurring throughout the nation.

2. INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE ABILITY TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

2.1. Background.

The current state of competition and regulation does not sufficiently deter cross-subsidization and protect consumers. This chapter explains why the Board cannot rely on either the level of competition in today's cable[16] and telco markets or on price cap regulation to protect consumers from improper cross-subsidization. Contrary to the unfounded Bell myth, the Bells' dominant position has not yet diminished sufficiently to enable regulators to rely on competitive forces to yield economically efficient rates. This chapter and Chapter 3 demonstrate that Verizon and cable companies possess the ability and the incentive to subsidize their new lines of business with their noncompetitive lines of business.

A myth often perpetuated by the Bells, including Verizon Communications, is that adherence to the Federal Communications Commission's ("FCC" or "Commission") accounting separations and cost allocation rules is irrelevant in today's purportedly competitive environment.[17] Another myth propounded by the Bells is that the presence of price cap regulation makes cost accounting irrelevant. This chapter rebuts both myths.

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[16] / Comcast and Cablevision serve approximately 90 percent of the total 2.5 million New Jersey subscribers in primarily non-overlapping geographic markets at the end of 2005. Comcast serves approximately 1,366,279 customers and Cablevision serves 963,576 customers. New Jersey Board of Public Utilities, Office of Cable Television, *Cable Facts 2006*, at 18.

[17] / The FCC is currently investigating options for reform of its accounting separations regime in FCC CC Docket No. 80-286. *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board*, FCC CC Docket No. 80-286, *Order and Further Notice of Proposed Rulemaking*, Rel. May 16, 2006 ("FCC Separations FNPRM"). The Rate Counsel is participating in the FCC's investigation. *See*, *e.g.,* Comments of the National Association of State Utility Consumer Advocates, the New Jersey Division of Rate Counsel and the Maine Office of the Public Advocate in CC Docket No. 80-286, August 22, 2006 and Reply Comments of the National Association of State Utility Consumer Advocates, the New Jersey Division of Rate Counsel and the Maine Office of the Public Advocate in CC Docket No. 80-286, November 20, 2006. The jurisdictional separations process determines the manner in which ILECs apportion regulated costs among jurisdictions (*i.e.,* interstate and intrastate jurisdictions). In conducting the jurisdictional separations process, carriers first assign the regulated cost of categories of plant and expenses (and sometimes among services with those categories). Carriers then allocate the costs in each category to the intrastate or interstate jurisdiction based upon: a relative use factor, a fixed allocator, or, by direct assignment (when allowed by Part 36 rules). 47 C.F.R. Part 69. Separations bears directly on regulators' ability to detect improper cross-subsidization particularly as carriers use extensive common network and resources to enter unregulated lines of business. These rules are discussed in more detail in Chapter 4.

2.2. Sufficient competition does not yet exist to constrain incumbents' market power.

In its proposed cable rules, the Board characterizes Verizon's position regarding the need for regulatory oversight in the following manner:

> Where there is competition in a market, Verizon states, artificial regulatory requirements are unnecessary and undesirable. Unnecessary, Verizon contends, because competitive forces act as an unseen guide that efficiently allocate resources and spur companies to lower prices, provide improved service quality and offer new and innovative products and services; and undesirable because they can increase the cost of market entry and discourage market entry by new providers.[18]

According to this line of reasoning, separations and cost allocation rules are irrelevant in today's purportedly competitive environment: the market place yields efficient, competitively established rates, and, therefore, cost accounting is an unnecessary burden on industry and regulators.[19] The fundamental fallacy in the Bells' arguments is that competitive forces do not yet exist to constrain the price of Verizon's (or cable companies') basic services nor does competition ensure that the industry offers basic services at acceptable levels of service quality.[20]

Furthermore, although the industry seeks to portray cost accounting as an albatross, rational suppliers in competitive markets rely on cost data to support strategic development and pricing. Those products for which key variables (such as consumer demand and revenues) are favorable relative to the associated costs will be pursued more actively.[21] Even a monopolist seeks information about average and marginal costs in

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[18] / Board of Public Utilities, Regulations of Cable Television Proposed Readoption with Amendments and New Rules: N.J.A.C. 14:18, at 3. In comments submitted to the FCC, Verizon similarly stated: "[i]n a market where all services – interstate, intrastate, wireline, wireless, local, long distance, basic, and enhanced – are competitively disciplined, regulatory cost allocation requirements such as the separations rules are not only unnecessary to protect ratepayers, but destructive of true competition." *In the Matter of Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. § 160 from Enforcement of Certain of the Commission's Cost Assignment Rules*, FCC WC Docket No. 05-342, Comments of Verizon, January 23, 2006, at 6-7.

[19] / In a similar vein, Qwest Communications stated last year, "[d]etailed separations/cost allocation rules and competition are basically incompatible -- because cost allocation has little or no affect (sic) on prices in a competitive environment." FCC CC Docket No. 80-286, Qwest *ex parte*, April 27, 2006, at 6.

[20] / Indeed, as the discussion of duopolies in Section 2.5 explains, competition does not exist in many of the unregulated telecommunications markets.

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

order to maximize profits. As one economics textbook states, "a profit-maximizing monopolist produces that quantity for which marginal revenue is equal to marginal cost."[22] Competitive companies seek to focus on financially lucrative products and to discontinue pursuit of the less profitable ones, and in order to achieve that focus, require relevant cost data.

2.3. Price cap regulation does not provide adequate consumer protection as telecommunications and cable companies enter each others' traditional lines of business.

A frequent Bell argument is that price cap or alternative regulation obviates the need for regulation (in the form of requiring accounting separations; structural separations; or even access to cost data). *Theoretically*, the purpose of price cap regulation is to yield rates that would exist in an effectively competitive market. However, *in reality*, price cap systems differ (with varying productivity factors, basket designations, rules for price changes, etc.), which is evidence of the fact that there is no "perfect" price cap system. Furthermore, intrastate and interstate rates in New Jersey are long overdue for re-initialization as a result of Verizon's increasing use of common and joint resources to enter new lines of business. Until such a re-initialization occurs, the FCC's and the Board's alternative forms of regulation cannot yield just and reasonable rates. Additionally, the FCC is considering the issue of the alleged supracompetitive special access prices being charged by incumbent local exchange carriers ("ILECs") in Docket WC 05-25, and as such, faith in the interstate price cap system would be seriously misplaced.[23]

Moreover, any particular price cap system corresponds with the regulators' best efforts to design a mechanism that will create the proper incentives for investment and yield reasonable rates. Price cap and other forms of alternative regulation do not protect consumers and competitors from the subsidization of competitive offerings with revenues derived from regulated services. Establishing going-in rates and assessing the impact of exogenous events on price cap and alternative regulation plans requires an assessment of a carrier's revenue requirement: if ILECs assign and allocate excess amounts to the

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[22] / Walter Nicholoson, *Microeconomic Theory, Basic Principles and Extensions,* Seventh Edition, 1998, at 548. Also, "[a]lthough a monopoly may earn positive profits in the long run, the size of such profits will depend on the relationship between the monopolist's average costs and the demand for its product." *Id.*, at 550, cite omitted.

[23] / In 2005, the most recent year for which FCC ARMIS data is available, Verizon Communications' rate of return on its interstate special access services was 42%. Federal Communications Commission, ARMIS Report 43-04, Table I. Separations and Access Data. Rate of return is calculated by dividing Net Return (Row 8041) by Average Net Investment (Row 8040).

intrastate jurisdiction, then state rates will be too high.[24]

States that have de-regulated or relaxed the regulation of local rates may consider separations to be an arcane and irrelevant concern: since a price cap plan, for example, may govern rate changes, the underlying costs seemingly are no longer an issue of concern. However, many current prices (often set under price caps) are not just and reasonable. Another limitation of price cap plans is that ILECs have an economic incentive to bring exogenous events that *raise* their costs to the attention of regulators but lack a corresponding incentive to alert regulators to exogenous events that *lower* their regulated costs. If price cap regulation worked efficiently, major exogenous events such as jurisdictional and regulatory shifts in the treatment of voice over Internet protocol ("VoIP"), ISP-bound traffic, and DSL should lead to a decline in rates under price caps.

Bell companies (such as Verizon in New Jersey) are entering video markets, yet are not providing regulators with data about how they account for these new costs. As Chapter 4 explains, the Board and the FCC have a statutory obligation to ensure that ILECs allocate the local loop fairly between regulated and unregulated services. A cap on rates (thus ensuring no increases, but also not ensuring decreases if the cost to provide basic local exchange service declines) is not sufficient evidence that rates are just and reasonable. The existing jurisdictional split of costs is based on a legacy network. If Verizon allocated a fair share of the common network to the interstate jurisdiction, based on regulatory decisions such as the treatment of DSL and broadband services, state costs would decline and state rate caps should similarly decline.

2.4. Neither the telecommunications nor cable companies' traditional markets are competitive and the incumbent carriers still dominate their respective markets.

2.4.1. Incumbent telecommunications companies and cable operators dominate their traditional turf.

Consumers who seek basic local exchange service (without any bundled offerings) continue to rely on Verizon's ubiquitous public switched network. In the

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

absence of mass market competition, consumers have little choice of suppliers of basic telephone service. Similarly, consumers who seek basic cable service (without any bundled offerings) continue to rely on cable company services, with little choice of suppliers of basic service. The competition that is emerging between the telco and cable industries is *not* for the consumer of either basic telephone or basic cable service, but rather for the consumer of bundled packages.

2.4.2. Evidence demonstrates that the incumbent cable operators still dominate the cable market.

Rising cable rates indicate that the cable market is not yet effectively competitive. In a report released in December 2006 detailing cable industry prices, the FCC concluded that cable prices have risen more than 5% in the past year, and over 93% since the period immediately preceding implementation of the 1996 Act.[25] Prices for expanded basic cable rose more than 6%, which is approximately twice the rate of inflation.[26] The report concludes that these price increases are indicative of inadequate competition in the cable industry.

In a statement accompanying the report, FCC Chairman Kevin J. Martin concluded that more competition is necessary in the cable market. "Cable does face some competition from DBS [satellite TV service], but our report reveals that DBS and cable do not seem to compete on price. In other words, the presence of a DBS operator does not have an impact on the price the cable operator charges its subscribers."[27] Commissioner Copps noted that the report "discloses that there is a positive relationship between local market share and cable prices, as well as between a provider's number of nationwide subscribers and prices. In other words, customers of a large national cable company that controls a large share of a local market generally pay more than customers of a company with either a smaller national or local market share."[28] Commissioner Jonathan S. Adelstein suggests that "Few other goods and services in America cost nearly twice today what they did in 1995."[29]

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[25] / *In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, FCC MM Docket No. 92-266, *Report on Cable Industry Practices*, Rel. December 27, 2006, at 1.

[26] / *Id.*

[27] / Statement of Chairman Kevin J. Martin, Re: *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, FCC MM Docket No. 92-266.

[28] / Concurring Statement of Commissioner Michael J. Copps, Re; *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, FCC MM Docket No. 92-266.

[29] / Concurring Statement of Commissioner Jonathan S. Adelstein, Re; *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, FCC MM Docket No. 92-266.

In contrast with these findings, the New Jersey Cable Telecommunications Association ("NJCTA") makes the following statement on its website:

> Is cable a monopoly? In a word – No . . . NJCTA members operate in a competitive environment and face all of the risks and rewards inherent in a free market system . . . To begin, cable franchise agreements are not exclusive - municipalities are free to (and, indeed, sometimes do) allow more than one cable operator to provide service to their residents. Any cable company can apply to compete against an existing cable operator and franchise agreements regularly come up for review and competitive bid. Few may find it economically sound to do so, because of market conditions beyond anyone's control.[30]

Yet, a map of New Jersey cable systems provided on the NJCTA's website divides geographic areas among association members and fails to show overlapping areas, suggesting that certainly the incumbents have chosen not to compete in each others' home regions.[31]

Appendix 1 provides additional details with respect to the cable industry customer base, products and prices, and revenues – both nationwide and in New Jersey.

2.4.3. Verizon's dominance of the local exchange market in New Jersey enables it to cross-subsidize its entry into new markets.

As the following graphics and discussion demonstrate, Verizon NJ owns or controls 97% of the end-user switched access telephone lines in New Jersey.[32]

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[30] / Statement of the New Jersey Cable Telecommunications Association at its website: http://www.cablenj.org/facts_cable_competition.asp.

[31] / Available at http://www.cablenj.org/about_map.asp. The map is also included in Appendix 1.

[32] / Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2005*, July 2006 ("FCC Local Competition Report"), at Tables 10 and 11. As noted previously, Embarq also provides service as an incumbent telecommunications carrier in New Jersey. However, its territory as an incumbent is relatively small in New Jersey and, as such, the focus in on Verizon's dominance of the local market. Embarq Corporation, formerly United Telephone Company (the Local Telecommunications Division of Sprint), served approximately 205,441 switched access lines in 2005 as an incumbent in New Jersey. By contrast, Verizon New Jersey served approximately 5,414,559 switched access lines in 2005. FCC ARMIS Report 43-08, Table II. Switched Access Lines in Service.

Table 1
Incumbents Own or Control 97% of the New Jersey Local Exchange Lines as of December 31, 2005

Total incumbent lines	4,714,621
Total CLEC lines	1,282,352
Total end-user switched access lines	5,996,973
CLEC share of end-user switched access lines	21%
CLEC resold lines	606,709
CLEC UNE lines	498,785
CLEC-owned lines	176,858
Total CLEC lines	1,282,352
CLEC-owned lines as a percent of all lines	3%
Percent of all lines owned or controlled by incumbent	97%

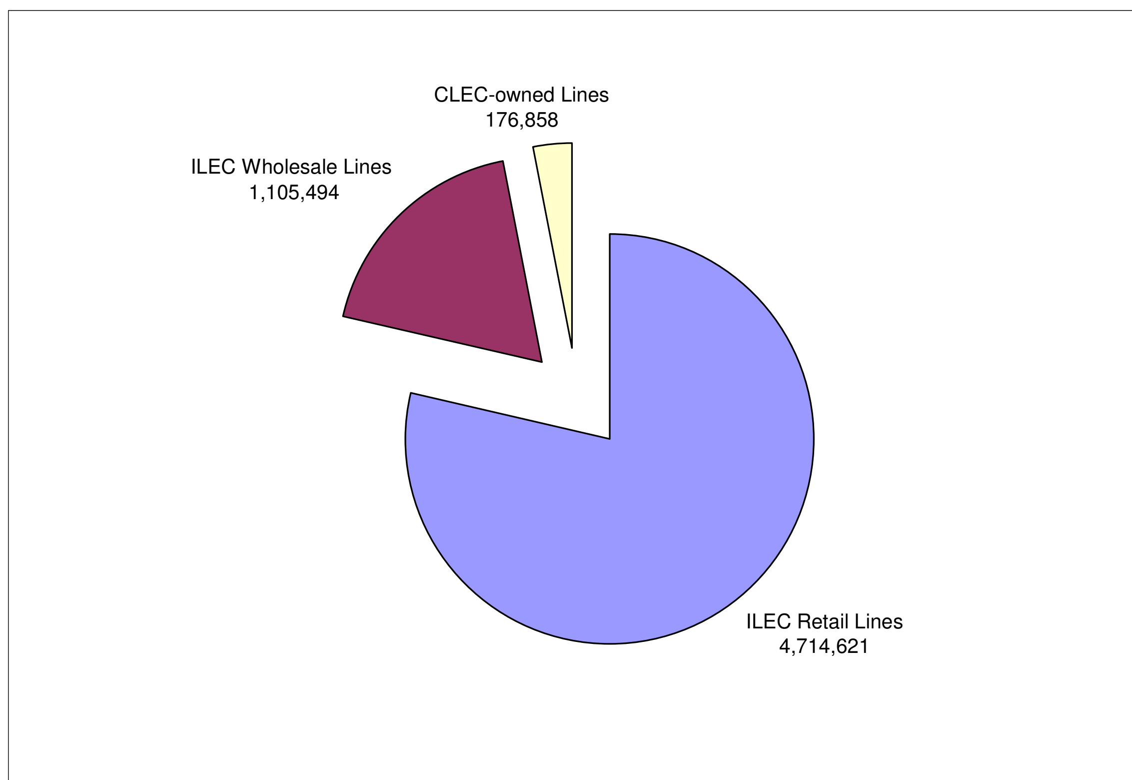
Source: FCC Local Competition Report, Tables 10 and 11.

Viewed solely on a retail basis, Verizon NJ has a 79% market share.[33] However, Verizon NJ dominates the local market either directly through its own retail services or indirectly by leasing wholesale facilities to its competitors (*i.e.*, the non-facilities-based competition that occurs through resale, unbundled network element platform ("UNE-P") and UNE loop). Most of the competitive local exchange carriers' ("CLECs") market share (*i.e.,* 86% of the CLECs' access lines) depends on incumbent facilities.

[33] / FCC Local Competition Report, at Table 11.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE ABILITY TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

Figure 1[34]
Incumbents Dominate the Local Market in New Jersey
(as of December 31, 2005)



Furthermore, competition from competitive providers using UNE-type arrangements is diminishing. Approximately 39% of the CLEC-provided end-user switched access lines in New Jersey as of December 31, 2005 were provided via UNEs.[35] Yet, the provision of CLEC lines through UNE or UNE-type arrangements is dropping off in the wake of the FCC's *Triennial Review Remand Order*.[36] UNE-P (UNEs with switching) peaked at 17.1 million nationwide in June 2004 and has declined 37% since that time to 10.8 million nationwide in December 2005.[37] In New Jersey, the number of

[34] / *Id.*

[35] / *Id.* This data overstates CLECs' presence because it includes any lines that MCI was providing in December 2005 as part of the CLEC data. MCI and Verizon merged in January 2006. *Id.*, at 2, footnote 5.

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

[37] / FCC Local Competition Report, at Table 4.

lines served with UNEs fell almost 51% from June 30, 2005 to December 31, 2005.[38] The dramatic decline in UNE-P lines contrasts sharply with UNE-P's former importance as an entry mode for competitive suppliers.

Furthermore, the position of CLECs negotiating access to UNE-P facilities is now seriously weakened due to the expiration of regulated UNE-P access in March 2006.[39] The declining prospect for robust wireline competition is best evidenced by the decision of MCI and legacy AT&T (two of the largest CLECs) to throw in the towel and merge with RBOCs. In its 2004 Annual Report, MCI made the following representation to its investors:

> As a participant in the competitive local telecommunications industry in the United States, we rely on the networks of established telephone companies or those of competitive local exchange carrier for some aspect of transmission. Federal law requires most of the established telephone companies to lease or "unbundle" elements of their networks and permit us to purchase the call origination and call termination services we need, thereby decreasing our operating expenses. However, as a result of recent litigation concerning portions of the FCC's Triennial Review Order that required the unbundling of switching, which is a critical component of UNE-P, the FCC has determined that beginning in 2006, certain discounts provided to us by the established telephone companies will cease. We are continuing to evaluate how the anticipated rise in UNE-P access costs will impact our ability to profitably provide Mass Markets subscription services, and the cost increase may force us to withdraw from certain markets. As a result, new local account installations and revenue may decrease from current levels in future periods. These regulatory changes will also increase costs for our other business segments as well and could adversely affect our competitive position in these segments.[40]

During the FCC's review of the Verizon/MCI merger, the two companies repeatedly suggested that MCI's business was declining and that MCI was not a competitor for

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[38] / *Id*., at Table 11; Industry Analysis and Technology Division, Wireline Competition Bureau, *Local Telephone Competition: Status as of June 30, 2005*, April 2006, at Table 11. The number of lines served by CLEC through UNEs fell from 1,014,796 in June of 2005 to 498,785 in December 2005. *Id.*

[39] / Furthermore, the FCC's conditions on the Verizon/MCI merger are weaker than those that have apparently been approved for the AT&T/BellSouth merger, providing less protection for New Jersey customers than for those in AT&T's 22-state region. Letter from Robert W. Quinn, Jr., Senior Vice President Federal Regulatory, AT&T to Ms. Marlene H. Dortch, Secretary, Federal Communications Commission, Re: Notice of Ex Parte Communications In the Matter of Review of AT&T Inc. and BellSouth Corp. Application For Consent to Transfer of Control, WC Docket No. 06-74, December 28, 2006 ("AT&T/BellSouth Merger Conditions"); *In the Matter of Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-75, *Memorandum Opinion and Order*, Rel. November 17, 2005 ("FCC Verizon/MCI Merger Order"), at Appendix G: Conditions.

[40] / MCI, Inc. Form 10-K, Annual Report for the fiscal year ended December 31, 2004, at 17.

Verizon's mass-market voice services.[41] Yet, AT&T and MCI were the largest CLECs competing with Verizon for mass market customers, casting doubt on the prospects for other wireline competitors.

Finally, the FCC estimates that 50% of the lines served by CLECs over their own loop facilities are provided over coaxial cable connections and 36% of CLEC residential lines are served by coaxial cable connections.[42] Thus, what little competition does exist relies on a cable-telco duopoly, which Section 2.5 below discusses.

2.4.4. Verizon's dominance extends to adjacent telecommunications markets.

Verizon is also quickly re-monopolizing the long distance market. One of the key regulatory freedoms that the Bell companies obtained in recent years is "Section 271" approval, which granted long distance authority. Furthermore, legacy SBC's acquisition of legacy AT&T, and Verizon's acquisition of MCI eliminated major rivals to all of the Bell companies, including Verizon NJ, further entrenching their control of the long distance market. Verizon offers diverse "Freedom" packages of local, long distance, data, and video services which, in turn, raises concerns regarding anti-competitive cross-subsidization.[43] Across Verizon's operating territory:

- Verizon reported a 50% increase in mass-market bundle subscriptions between June 30, 2005 and June 30, 2006 and, as of September 30, 2006, provided 7.5 million mass market customers with its Freedom packages;[44]

- The total number of long distance lines served by Verizon increased 15.5% between year-end 2003 and year-end 2004, and increased 5.7% between year-end 2004 and year-end 2005.[45]

The Bell companies have been far more successful in entering new markets than have CLECs. The 1996 Act was enacted more than a decade ago, and yet CLECs

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41 / *Verizon Communications, Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-75, Application for Transfer of Control, March 11, 2005, Appendix 1: Public Interest Statement, at 49 and Declaration of Robert W. Crandall and Hal J. Singer, at para. 33.

42/ FCC Local Competition Report, at 2.

43 / See Appendix 2, which includes illustrative copies of Verizon's web pages.

44 / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at 6. The number of subscribers to Verizon Freedom packages (which include local wireline services with a combination of long distance and/or Internet access service) rose from approximately 5 million in the third quarter of 2005 to 7.5 million in the third quarter of 2006.

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

collectively have garnered, at most, a 19% percent share in the local market.[46] In approximately half the time, Verizon has made twice the inroads into the long distance market than all the CLECs have made over ten years. In other words, collectively the CLECs have been less than half as successful as the Bells have been, and have taken about twice as long as the Bells to achieve that tenuous success.

Verizon's substantial and unique advantage in the race to offer bundled packages is directly tied to its century-long relationship with consumers, as the primary link to the public switched telephone network. Mass market consumers, through many years of predictable demand for Verizon's essential local telephone services, provided a largely risk-free source of revenue, which enabled Verizon to establish a formidable position in the telecommunications marketplace. Also, Verizon's access to this vast customer base gives it an enviable edge in marketing new products.

As Verizon moves into new lines of business, including broadband and video markets, it is essential to ensure that basic noncompetitive services are not subsidizing these new services and that low-volume, demand-inelastic customers are not subsidizing high volume customers. It is also essential to ensure that Verizon does not neglect the more "mundane" responsibilities of installing and repairing basic telephone service in a timely manner.[47] Verizon's dominance of adjacent markets throughout New Jersey provides it with a significant opportunity to cross-subsidize its entry into new lines of business, such as its video service. Furthermore, the lack of competition means that regulators cannot rely on market forces to ensure proper cost allocation.

2.4.5. Intermodal competitors do not constrain dominant carriers' market power.

Contrary to industry hype, intermodal services (*i.e.,* non-wireline services) do not adequately constrain Verizon's market power. Wireless, facilities-based VoIP, and "over-the-top" VoIP services do not constrain Verizon NJ's prices and service quality for basic voice grade service. The product supplied by "over the top" providers, such as Vonage, for example, requires that subscribers provide their own broadband Internet access (*i.e.,* rely on the cable-telco duopoly). In its *Verizon/MCI Merger Order*, the FCC excluded over-the-top VoIP services from the relevant product market.[48] In so doing, the Commission noted that the various over-the-top services:

46/ According to FCC-reported data, as of December 31, 2005, CLECs account for 18% of end-user switched access lines, down from 19.1% in June 2005. FCC Local Competition Report, at Table 1.

47 / In Verizon Communications' second quarter 2006 Investor Quarterly, Ivan Seidenberg, Verizon's chairman and CEO states: "Verizon Telecom is tightly controlling costs in traditional businesses as we make the fiber network investments to accelerate growth and market expansion." Verizon Communications, *Investor Quarterly: VZ Second Quarter 2006,* August 1, 2006, at 2. *See* Sections 3.9.1 through 3.9.3 for analysis of Verizon NJ's service quality.

48/ *FCC Verizon/MCI Merger Order*, at para. 89.

> . . . differ significantly in their service characteristics, including quality of services and price. The extent to which consumers view these services as substitutes for traditional wireline local service may vary based on these differences. In addition, the requirement that a customer have broadband access to be able to use certain over-the-top VoIP services affects the substitutability of those services with wireline local services.[49]

The FCC noted that such a requirement for broadband access made substitution "uneconomical" and further concluded that even those consumers who already subscribed to broadband services may still not be willing to view over-the-top services as substitutes depending on "the attributes of the service and the consumer's willingness to trade off service characteristics for lower prices."[50] A study conducted last year by Brix Networks corroborates the FCC's analysis that VoIP services may not have the same level of quality and concludes that, based on approximately one million VoIP connections tested through its Web site, 20 percent had unacceptable quality, which was an increase from 15 percent the year before.[51] Furthermore, VoIP's price advantage may also be diminished in the future. The FCC recently issued an order wherein, among other things, it requires VoIP providers to contribute to universal service.[52] The impact of this new requirement on VoIP prices and demand is uncertain.

Finally, the Board has similarly made a finding that intermodal services do not constrain Verizon NJ's market power. The Board undertook its own analysis of the state of competition in New Jersey as part of its investigation of the proposed Verizon/MCI merger. In its Order approving the merger,[53] the Board found that intermodal technologies do not currently serve as an economic substitute for wireline services in New Jersey's local market for either enterprise or mass market customers.[54] The Board acknowledged Verizon's and MCI's position that price constraining competition takes place at the margins, and thus intermodal competition need not reach all consumers, but the Board faulted the Petitioners for failing to "actually opine as to how large a percentage of 'early adopters' is required for pricing discipline to occur."[55] In reviewing the evidence, the Board made the following conclusions with respect to the mass market:

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[49]/ *Id.* (citation omitted).

[50]/ *Id*.

[51]/ "Study: Net telephony quality worsening," Marguerite Reardon, C/Net News.com, July 25, 2006, http://news.com/2102-7352_3-6097912.html?tag=st.util.print. *See*, also, "Clear as a Bell One Day, Fuzzy and Garbled the Next," Ken Belson, *New York Times*, September 27, 2006.

[52]/ *In the Matter of Universal Service Contribution Methodology*, FCC WC Docket No. 06-122, *Report and Order and Notice of Proposed Rulemaking*, Rel. June 27, 2006, paras. 16, 34-62.

[53]/ *In the Matter of the Joint Petition of Verizon Communications Inc. and MCI, Inc. for Approval of Merger*, New Jersey Board of Public Utilities Docket No. TM05030189, *Order of Approval*, April 12, 2006 ("NJ BPU Verizon/MCI Merger Order").

[54]/ *Id.*, at 33-35, 36.

[55]/ *Id.*, at 36.

> In the case of the aforementioned technologies except wireless, market penetration rates are very low. Thus, we are not willing to accept on this record that intermodal technologies such as VoIP, WiFi, WiMAX and cable telephony currently constrain Verizon's wireline pricing to a meaningful degree.[56]

The Board also found the rate at which consumers were "cutting the cord" was insufficient to constrain Verizon's wireline pricing. The Board agreed with the Rate Counsel in finding that "wireless service is currently viewed by the majority of its users as a supplement to wireline service rather than a substitute."[57]

Moreover, the Board found that none of the intermodal technologies, which Verizon and MCI characterized as substitutes for enterprise wireline services, sufficiently disciplined Verizon NJ's behavior in the small business market. The Board concluded that the various technologies identified by Verizon and MCI are either not true economic substitutes (*e.g.,* wireless and VoIP) or have not been adopted by enough subscribers to provide price constraining competition (*e.g.,* cable, WiFi).[58] The Board stated:

> . . . acknowledging the increasing presence of such technologies is not the same as concluding that they sufficiently mitigate competitive harms created by the merger by constraining ILEC wireline pricing. In fact, we conclude that in New Jersey such alternative technologies have not yet had this effect in the business market.[59]

Furthermore, Verizon has a stake in some of these "competitive" intermodal alternatives, such as wireless services. For example, the fact that Verizon offers bundles which include its own wireline and wireless services together in one package provides evidence that wireless is viewed, even by the carriers themselves, as a complement, rather than substitute, to wireline service. Verizon Communications reported to its investors in the third quarter of 2006 that Verizon Wireless is the largest US wireless company, based on revenues.[60]

The Bells' filings with the FCC and their statements to investors provide further evidence that the companies themselves view wireline and wireless services as complements. One of the reasons given by SBC and AT&T for their merger was the simplified governance of Cingular and the facilitation of "the merged firm's ability to

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[56]/ *Id.*

[57]/ *Id.*

[58]/ *Id.*, at 33-35.

[59]/ *Id.*, at 35.

[60]/ Verizon Communications, *Investor Quarterly: VZ Third Quarter 2006*, October 30, 2006, at 2.

jointly market wireline and wireless services to mass market and business customers."[61] In 2005, Verizon Communications stated in a quarterly report to investors: "Verizon Freedom plans help retain and win back customers by offering local services with various combinations of long-distance, wireless and Internet access, available on one bill."[62] In August 2006, Verizon Communications reported to investors that Verizon Freedom packages "have been instrumental in retaining retail wireline customers."[63] Verizon Communications announced in October 2006 a new service offered to Texas consumers, "Verizon Complete Freedom" that includes both "traditional" and wireless phones and airtime-free calling between Verizon wireless and home phones. The service provides one bill and one integrated voice mail service.[64] On a recent earnings conference call Verizon's Chief Financial Officer and Executive Vice President, Doreen Toben, stated:

> We tend to view additional or secondary line losses being driven more by secular change and technology substitutions than competition. In fact, our own broadband initiatives are influencing customers to disconnect their additional lines. Our bundling and broadband initiatives are starting to take hold. We believe that this expanded customer relationship will improve revenue per household and increase customer loyalty, thereby improving retention.[65]

2.5. The cable-telco duopoly does not provide effective competition.

In September 2005, the FCC adopted its *Wireline Broadband Order*, which determined that wireline broadband Internet access services were "information" services, and which sought to adopt a "consistent regulatory framework across platforms by

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[61]/ *In the Matter of BellSouth Corporation and AT&T Inc. Application Pursuant to Section 214 of the Communications Act of 1934 and Section 63.04 of the Commission's Rules for Consent to the Transfer of Control of Bellsouth Corporation to AT&T Inc*, WC Docket No. 06-74, Application for Consent of Transfer of Control, filed March 31, 2006, Declaration of Dennis W. Carlton and Hal S. Sider, at para. 10 (emphasis added). *See*, *also*, *Id.*, at para. 52, stating "The proposed transaction eliminates impediments to developing innovating marketing strategies involving wireless services. Such bundles enable customers to have a single point of contact for a broader range of services."

[62]/ Verizon Communications, Inc. Press Release, "Verizon Reports Continued Strong Results with EPS Growth of 8.6 Percent, Revenue Growth of 6.6 Percent," April 27, 2005, available at http://investor.vzmultimedia.com/news/view.aspx?NewsID=621.

[63] / Verizon Communications, *Investor Quarterly: VZ Second Quarter 2006,* August 1, 2006, at 6.

[64] / Verizon Communications, *Investor Quarterly: VZ Third Quarter 2006*, October 30, 2006, at 16.

[65] / VZ – Q3 2006 Verizon Earnings Conference Call, October 30, 2006, Thompson Financial, Final Transcript available at http://investor.verizon.com/news/20061030/3q06_vz-transcript.pdf, at 4.

regulating like services in a similar functional manner . . ."[66] (*i.e,.* treating cable modem and DSL services in the same manner).[67] The FCC opted to adopt a "lighter regulatory touch" in order to "promote the availability of competitive broadband Internet access services to consumers, via multiple platforms, while ensuring adequate incentives are in place to encourage the deployment and innovation of broadband platforms consistent with our obligations and mandates under the Act."[68] The FCC described the broadband Internet access market in the following manner:

> We fully recognize that not all American households can choose between cable modem and DSL-based Internet access service today. But a wide variety of competitive and potentially competitive providers and offerings are emerging in this marketplace. Cable modem and DSL providers are currently the market leaders for broadband Internet access service and have established rapidly expanding platforms. There are, however, other existing and developing platforms, such as satellite and wireless, and even broadband over power line in certain locations, indicating that broadband Internet access services in the future will not be limited to cable modem and DSL service.[69]
>
> We expect providers of both platforms will continue to invest and extend the reach of their services. We anticipate that, as the availability of cable modem and DSL broadband Internet access services grows with the modernization of network infrastructure and increased service deployment, more households will have the option of choosing between the cable and DSL broadband options. Increased intermodal and intramodal competition will continue to encourage these two broadband providers to deploy broadband Internet access services throughout their respective service areas. In addition, the threat of competition from other forms of broadband Internet access, whether satellite, fixed or mobile wireless, or a yet-to-be-realized alternative, will further stimulate deployment of broadband infrastructure, including more advanced infrastructure such as fiber to the home.[70]

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[66]/ *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, Universal Service Obligations of Broadband Providers*, CC Docket No. 02-33, et al., *Report and Order and Notice of Proposed Rulemaking*, 20 FCC Rcd 14853 (2005) ("Wireline Broadband Order"), at para. 1. *See*, *also*, para. 5.

[67] / Rate Counsel and the authors of this paper respectfully disagree with the FCC's determination that broadband Internet access services are information services, and consider them, instead, to represent transmission.

[68] / *Wireline Broadband Order*, at para. 3.

[69] / *Id.*, at para. 50 (notes omitted).

[70] / *Id.*, at para. 57.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE ABILITY TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

The FCC suggested that although the number of subscribers to cable modem and DSL services was very small, it expected that "[a]s the number of subscribers grows, so does the opportunity for alternative technologies and their respective providers."[71]

Yet, there is indisputable evidence that a cable-telco duopoly dominates the merging voice/data/video markets still today. Popular and trade press routinely discuss the cable-telco duopoly,[72] and recent consumer advocate and FCC Commissioner statements highlight the emerging duopoly.[73] In a dissenting statement accompanying the Commission's Order approving the division of Adelphia assets between Time Warner and Comcast, FCC Commissioner Copps stated:

> I am worried that this decision tightens the grip that cable companies share with telephone companies over our nation's broadband access. FCC data show that these two industries control some 98 percent of the broadband market. Despite this, the majority's Order goes on at length about the supposedly competitive broadband market. Indeed, the competitive picture the majority spins is at odds with too many other reports. A few weeks ago, the Congressional Research Service characterized the broadband market as a "cable and telephone duopoly."[74]

The Congressional Research Service report to which Commissioner Copps referred concluded: "With only limited alternatives to the cable and telephone broadband duopoly

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[71] / *Id.*, at para. 61.

[72] / *See*, *e.g.*, "A Wiring War Among Giants," Ken Belson, *The New York Times*, Section 14, at 1 and 10, December 10, 2006; Jason Lee Miller, "What An Un-Neutral Net Means to You," *Webpronews.com*, December 27, 2006; James S. Granelli, "Ma Bell is calling again, with a big voice," *latimes.com,* December 26, 2006; Brier Dudley, "Broadband rush is risky, Seattle," *seattletimes.com*, July 17, 2006; Peter Grant, "Cable Firms Woo Business in Fight for Telecom Turf," *The Wall Street Journal*, January 17, 2007, A1.

[73] / Mark Cooper, Director of Research for the Consumer Federation of America described the telco-cable duopoly in detail in testimony before the United States Senate Committee on Commerce, Science and Transportation in hearings regarding Competition and Convergence on March 30, 2006. His testimony is available at http://commerce.senate.gov/pdf/cooper-033006.pdf. Dr. Cooper noted that today, "there are only two local, last mile communications networks that can provide a fully functional broadband network to the residential consumer – the incumbent local telephone companies and the incumbent cable operators. Two is not a sufficient number to ensure vigorous competition, and both sets of incumbents have a miserable record of anticompetitive, anti-consumer behavior." *Id.*, at 4.

[74] / Dissenting Statement of Commissioner Michael J. Copps, Re: *Applications for Consent to the Assignment and/or Transfer of Control of Licenses; Adelphia Communications Corporation (and subsidiaries, debtors-in-possession), Assignors, to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and subsidiaries, debtors-in-possession), Assignors and Transferors, to Comcast Corporation (subsidiaries), Assignees and Transferees; Comcast Corporation, Transferor, to Time Warner, Inc., Transferee; Time Warner In., Transferor to Comcast Corporation, Transferee, Memorandum Opinion and Order*, FCC MB Docket No. 05-192, July 13, 2006; *See,* also, Statement of Commissioner Michael J. Copps, Re: *Amendment of Part 15 Regarding New Requirements and Measurement Guidelines for Access Broadband over Power Line; Carrier Current Systems Including Broadband over Power Line Systems, Memorandum Opinion and Order*, August 3, 2006.

for the foreseeable future, and with the cable and telephone companies both pursuing largely the same business plan, the broadband providers might have both the incentive and the ability to exploit their control over access to end users to restrict competition (and the innovation it might bring) and harm consumers."[75] FCC Commissioner Copps cited the report again in August of 2006 in his statement regarding the Commission's Order defining the regulation of Broadband over Power Line services, stating:

> We all have high hopes for Broadband over Power Line and I think we would all like to see some non-duopoly pipes bringing broadband access to, particularly, hard-to-reach Americans. We are behind the game in putting high-speed, high value bandwidth to work for all our citizens. You know something is wrong when the best case scenario is that a consumer has a choice between two broadband connections, both of which are more expensive and considerably slower than what consumers in other industrialized nations enjoy. And that's how it works in our wealthy metropolitan areas. Over much of the rest of America, it just gets worse . . . The reason we're so far behind, of course, is that – in the words of the Congressional Research Service – our residential broadband market is a flat out "cable and telephone duopoly." Indeed, this market has an HHI index of roughly 5,500 to 5,800 – well over three times what the Department of Justice considers "highly concentrated." And this is not just some run of the mill product like a toaster or a lawnmower – it is the data pipe over which all future communications will run.[76]

FCC Commissioner Adelstein, in his statement regarding the FCC's approval of the merger between AT&T Inc. and BellSouth Corporation, also has taken note of the cable-telco duopoly, referring to "a market in which telephone and cable operators control nearly 98 percent of the market."[77]

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[75] / Charles B. Goldfarb, *Access to Broadband Networks*, Congressional Research Service, CRS Report for Congress, Order Code RL33496, June 29, 2006, at 17.

[76] / Statement of Commissioner Michael J. Copps, Re: *Amendment of Part 15 Regarding New Requirements and Measurement Guidelines for Access Broadband over Power Line; Carrier Current Systems Including Broadband over Power Line Systems, Memorandum Opinion and Order*, August 3, 2006. The Hirfindahl Hirschman Index ("HHI") is a well-known measure of market concentration. U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, issued April 2, 1992, revised April 8, 1997 ("Horizontal Merger Guidelines"), § 1.5; F.M. Scherer, *Industrial Market Structure and Economic Performance*, Rand McNally & Company, Chicago, 1970, 50-52. The HHI is computed as the sum of the squares of each firm's market share. If a single firm serves a market, the HHI is 10,000 (the highest possible HHI), and if two firms each equally serve a market the HHI of that market is 5000. The larger the HHI, the greater the concentration. Markets with HHI below 1000 are considered to be unconcentrated; those with an HHI between 1000 and 1800 to be moderately concentrated, and those with an HHI above 1800 to be highly concentrated. *Horizontal Merger Guidelines,* § 1.51.

[77] / Statement of Commissioner Jonathan S. Adelstein, Concurring, Re: *AT&T Inc. and BellSouth Corporation Application for Transfer of Control, WC Docket No. 06-74, Memorandum Opinion and Order*, December 29, 2006.

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The Chairman of the House Subcommittee on Telecommunications and the Internet, U.S. House of Representatives, referred to the broadband, or digital, duopoly at a conference in January 2007:

> The second piece of bad news is that broadband service to residential consumers in the United States is dominated by a "digital duopoly" of two technologies – cable modem and telephone company DSL service. If one looks at the FCC data, what one finds is that even simply counting services that provide just 200 kilobits per second in ONE direction, alternative technologies such as wireless services or broadband-over-powerlines make up just over 1% of the market. When you count those services to residential consumers offering 200 kilobits per second in TWO directions, the FCC data shows that the share of wireless and powerline-based technologies is under 1% of the residential market. So, again, the cable industry's cable modem and the telephone companies' DSL technologies are going to be a digital duopoly into residential homes for the foreseeable future. This has implications for affordability, for innovation, and for the need for sensible rules for network neutrality to safeguard the Internet.[78]

Chapter 5 further discusses the fact that the widespread support for net neutrality is based largely on concerns of duopoly-controlled information pipes.

2.5.1. Evidence of a duopoly market structure.

FCC data corroborates press, regulator, and consumer advocate descriptions of the market as a duopoly. As of year-end 2005, cable modem and ADSL technology represented 57.5% and 40.5%, respectively of residential high-speed lines.[79] Thus, the cable and telephone companies control at least 98% of the broadband pipes to homes in the United States.[80] Figure 2 shows the growth in residential cable modem and DSL lines from year-end 1999 to year-end 2005, nationwide.

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[78] / Congressman Ed Markey (7th District Massachusetts) Statement at the Voice On the Net (VON) Conference, January 18, 2007, Boston, Massachusetts, available at http://markey.house.gov/index.php?option=com_content&task=view&id=2116&Itemid=46. Congressman Ed Markey is the current Chairman of the House Subcommittee on Telecommunications and the Internet, U.S. House of Representatives.

[79] / FCC High-Speed Services July 2006 Report, at Chart 6. The FCC defines high-speed lines as services to end-user locations delivering speeds that exceed 200 kbps in at least one direction. Advanced services (a subset of high-speed lines) provide services with speeds exceeding 200 kbps in both directions. *Id.*, at Notes for Tables 1-5 and Charts 1-9, Note 1. Additionally, optical fiber to the subscriber's premises (*e.g.* Fiber-to-the-Home) – presumably served by the telecom companies – represents 0.5% of the market and SDSL and other wireline technologies represent 0.3% of the residential high-speed line market. *Id.*

[80] / As noted above the telephone companies also provide fiber and wireline technologies for high-speed access. The FCC reports that *incumbent* local exchange carriers provided 96.3% of the reported ADSL lines and 55.3% of the traditional wireline connections. "When all technologies are considered, incumbent LECs reported 45.1% of total high-speed connections. *Id.*, at 2.

Figure 2[81]
Residential High-Speed Lines, 1999 to 2006

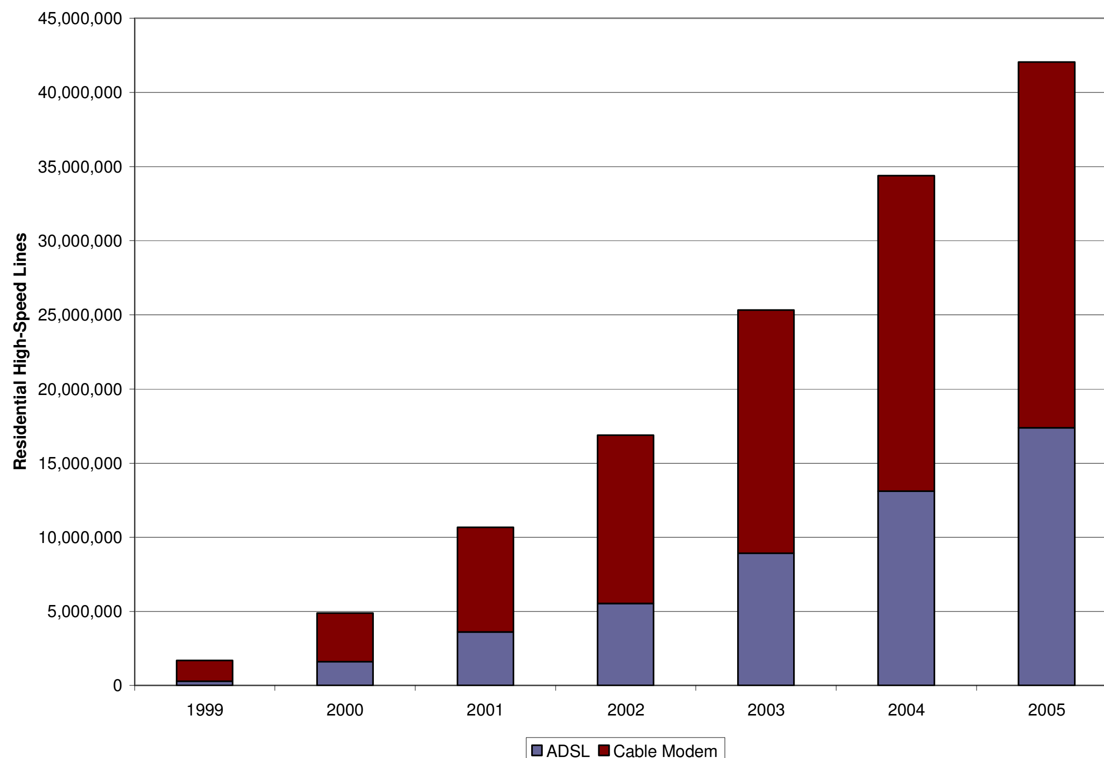


Figure 3, below, shows that in New Jersey there were 1,989,802 high-speed lines in service as of December 31, 2005, 540,382 (or 27%) were ADSL[82] and 1,205,182 (or 61%) were served by cable modem technology. Additionally, 7,967 lines were SDSL,[83] 13,556 were "other" traditional wireline services, and 8,317 were fiber lines (representing another 1.5% of the total high-speed lines in service).

As of year-end 2005, there were no broadband over powerline connections and the numbers for satellite, fixed wireless, and mobile wireless were "withheld to maintain firm confidentiality" indicating the very small percentage of lines these categories represent.[84] While there were more cable modem connections reported as of year end

[81] / *Id.*, at Table 3. The data in Figure 2 is year-end data (*i.e.* December 31, 2005 for 2005).

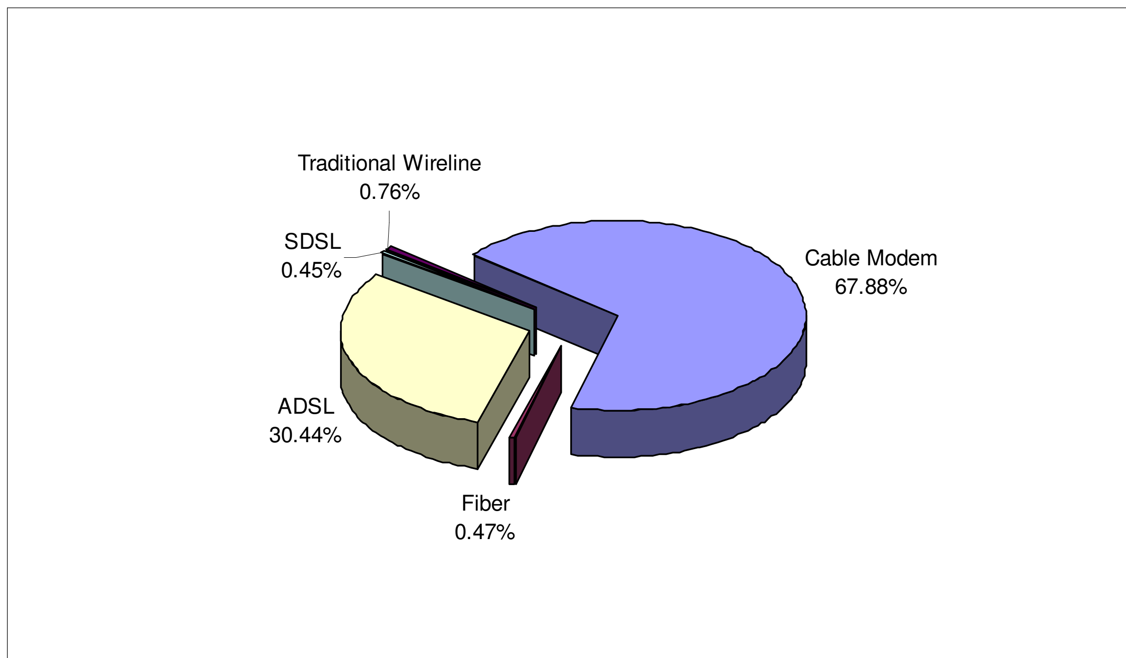
[82] / ADSL refers to asymmetric digital subscriber line technology, which provides speeds in one direction greater than speeds in the other direction (generally higher download than upload speeds). *See*, *e.g.*, *Id.*, at Note 2.

[83] / SDSL refers to symmetric digital subscriber line, which provides the same download and upload speeds. *See*, *e.g.*, *Id.*

[84] / *Id.*, at Table 9.

2005, the rate at which telephone companies added ADSL subscribers nationwide outpaced cable modem subscriptions additions in 2005.[85]

Figure 3[86]
The Cable-Telco Duopoly Dominates the Provision of High-Speed Lines in New Jersey



2.5.2. Defining a duopoly.

Duopoly, which is an extreme form of an oligopoly, is only one step away from a monopoly. In an oligopolistic market, a small number of firms compete in that market, and the firms' behavior, cost functions, and strategic interaction, as well as consumers' demand functions, affect the market structure.[87] One textbook describes the behavior of firms in an oligopoly as follows:

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[85] / *Id.*, at 2.

[86] / *Id.*, at Table 9.

[87] / Mas-Colell, Andreu, Michael D. Whinston and Jerry R. Green, *Microeconomic Theory* (New York: Oxford University Press, 1995), at 387 through 427; F. M. Scherer, *Industrial Market Structure and Economic Performance, Rand McNally & Company* (1970), at 131 through 157; Robert S. Pindyck and Daniel L. Rubinfeld, *Microeconomics*, 6th ed., Upper Saddle River, NJ: Pearson Prentice Hall, 2005, at 435-457. *See*, also, William G. Shepherd, *The Economics of Industrial Organization*, 3rd ed., Englewood Cliffs, NJ: Prentice-Hall, Inc., 1990. Shepherd states that oligopoly "is about fewness and interdependence. It ranges from pure duopoly, with just two firms, down to loose oligopolies with eight to ten substantial firms." *Id.*, at 72. The defining feature of an oligopolistic market is that the firms must consider the other firms' likely responses to their own actions in the market. *Id.*

> Any realistic theory of oligopoly must take as a point of departure the fact that when market concentration is high, the pricing decisions of sellers are interdependent, and the firms involved can scarcely avoid recognizing their mutual interdependence. If they are at all perceptive, the managers of oligopolistic firms will recognize too that profits will be higher when cooperative policies are pursued than when each firm looks only after its own narrow self-interest. As a result, we should expect oligopolistic industries to exhibit a tendency toward the maximization of collective profits, approximating the pricing behavior associated with pure monopoly.[88]

One of the defining features of the oligopoly (of which duopoly is one type) is that firms are engaged in strategic interactions with each other. Economist James Friedman notes that "[p]urely competitive markets lack this strategic interaction, because the choices of a single firm have no effect on the market price of the homogenous good the firms produce."[89] Certainly, a duopoly does not provide "effective competition." One Industrial Organization text states that effective competition requires "a reasonable degree of parity among the competitors" and enough competitors to prevent effective collusion and suggests that the largest market share of any competitor should be 15% or 20% of the market.[90] As the market becomes more concentrated, moving from oligopoly to duopoly, the likelihood of successful collusion becomes greater. One economist describes the spectrum in this manner: "The higher the concentration, the greater the likelihood that collusion will be successful . . . Accordingly, collusion is likely to crystallize and persist in tight oligopoly, whereas it is likely to fail in loose oligopoly. Tight oligopoly tends to become a 'shared monopoly,' as joint maximizing prevails over independent action."[91]

The FCC has contemplated the anticompetitive effects of market consolidation in recent proceedings. For example, in discussing its analytical framework for its review of the merger of Verizon Communications, Inc. and MCI, the FCC cited its earlier reasoning in the *EchoStar/DirectTV Order*:

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[88] / F. M. Scherer, *Industrial Market Structure and Economic Performance*, Rand McNally & Company (1970), at 157. Similarly, "An oligopoly is a market having few firms (but more than one firm) on the supply side and a very large number of buyers on the demand side, each of whom makes a negligible contribution to the market demand function. A buyer will take market conditions as given, for he cannot affect them, but a seller will inevitably be preoccupied with guessing the behavior to be expected from rival sellers . . . The key distinguishing feature that sets oligopoly apart from competition and from (textbook) monopoly is that oligopolists are strategically linked to one another. The best policy for one firm is dependent on the policies being followed by each rival firm in the market." James W. Friedman, *Oligopoly Theory*, Cambridge: Cambridge University Press, 1983, at 1.

[89] / James W. Friedman, *Oligopoly Theory*, New York: Cambridge University Press, 1983, at 2.

[90] / William G. Shepherd, *The Economics of Industrial Organization*, 3rd ed., Englewood Cliffs, NJ: Prentice-Hall, Inc., 1990, at 5, 16.

[91] / *Id.*, at 73.

> Unilateral effects arise when the merging firm finds it profitable to alter its behavior following the merger. Examples of unilateral effects include a merging firm's raising its price or reducing the quantity it supplies. Coordinated effects, in contrast, arise when competing firms, recognizing their interdependence, take actions "that are profitable for each of them only as a result of the accommodating reactions of others." Because coordinated effects generally are more likely the smaller the number of firms in a market, mergers may significantly increase the likelihood of coordinated effects by reducing the number of firms. Examples include explicit collusion, tacit collusion, and price leadership.[92]

The FCC also noted in its *Verizon/MCI Merger Order*:

> It is generally recognized that the likelihood of coordinated effects depends on a number of factors, including the ease with which firms can reach tacit agreement, the incentive of firms to cheat, and the ability of the remaining firms to detect and punish such cheating.[93]

Collusion among firms in a duopoly need not be direct and can be "tacit," such as parallel pricing.[94] Indeed, at a recent analyst conference, AT&T Chairman and CEO Ed Whiteacre suggested that there would not be a "price war" between cable and telephone companies, stating "We're not going to chase that down." Instead, Whiteacre suggested that the companies would compete on the basis of who offers more services in their packages.[95] Such a view suggests that the companies will be competing to offer expensive bundles with lots of extras to the "high value" customers instead of reducing prices for basic services.[96]

92/ *FCC Verizon/MCI Merger Order*, at fn 84, citing *EchoStar/DirecTV Order*, 17 FCC Rcd at 20609, para. 152.

93 / *Id.*, at para. 52, citing Jean Tirole, *The Theory of Industrial Organization* 239 (1988); George Stigler, "A Theory of Oligopoly," in *The Organization of Industry* 39 (1968); Alexis Jacquemin and Margaret E. Slade, "Cartels, Collusion, and Horizontal Merger," in *The Handbook of Industrial Organization* 415 (1989).

94 / William G. Shepherd, *The Economics of Industrial Organization*, 3rd ed., Englewood Cliffs, NJ: Prentice-Hall, Inc., 1990, at 74.

95/ Roger Chang, "AT&T CEO Backs View of Double-Digit Adjusted EPS Growth," *The Wall Street Journal Online*, May 31, 2006.

96 / *See*, *e.g.*, Mark Cooper, Director of Research for the Consumer Federation of America described the telco-cable duopoly in detail in testimony before the United States Senate Committee on Commerce, Science and Transportation in hearings regarding Competition and Convergence on March 30, 2006. His testimony is available at http://commerce.senate.gov/pdf/cooper-033006.pdf; *In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, FCC WC Docket No. 06-74, Comments of the New Jersey Division of the Ratepayer Advocate, June 5, 2006, at 5.

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While there are many positive benefits of convergence,[97] market consolidation and the marketing of "triple-play" and "quadruple play" bundles has tightened the hold of the telephone and cable companies on the market. One industry analyst characterizes the bundled services market as a duopoly. While duopoly is not, *de facto*, harmful to consumers, Paul R. Zimmerman describes the outcome in this manner:

> Of course, from a *policy* perspective, the ultimate question is whether two providers is sufficient to induce "competitive" outcomes in the local telecommunications market, i.e. retail prices that reflect the long-run incremental cost of provisioning the various services. And while it may very well be the case that the local exchange access market is most efficiently structured as a "natural duopoly" due to its demand and technological characteristics, regulators and policy makers cannot simply ignore the potential harms that economic theory often suggest will arise with fewer firms competing in a market. For instance, policy makers will need to address the possibility of a strategic "détente" between these two large facilities-based players (*e.g.*, the RBOC and cable company "splitting" the market by price matching each other's offerings, or simply competing "less aggressively" in other firm's traditional core line of business) while recognizing the potentially significant consumer benefits associated with product and service bundling/integration.[98]

In discussing both the ambition and ability of the RBOCs to squeeze intermodal competition out of the telecommunications market by strategically bundling services

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97/ Verizon and MCI described the implications of convergence in this manner in their application to the FCC seeking approval of their proposed merger:

> The transformation of the communications industry is a result of profound changes in technology. The deployment of digital, two-way, broadband capabilities, along with the growth of IP-based technologies, has finally brought about the long anticipated "convergence" among once-separate networks and providers. Wireline voice, data, cable, wireless, and satellite networks are now all capable of delivering an increasing array of innovative voice, data, and video services faster than ever before. Larger business and mass-market customers alike have enthusiastically adopted these new technologies and services, and increasingly use them both along with and in place of traditional offerings. These developments have shattered the artificial separation between local and long distance that has shaped industry regulation for the past two decades. The new providers rarely, if ever, offer the new services solely within these antiquated boundaries. And customers have not merely accepted these broader offerings, but have also embraced the newfound opportunity to purchase communications services on an integrated basis, from integrated providers.

Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control, FCC WC Docket No. 05-75, Application for Transfer of Control, March 11, 2005, Appendix 1: Public Interest Statement, at 2.

98 / Paul R. Zimmerman, U.S. Federal Communications Commission, "Strategic Bundling in Telecommunications and its Antitrust Implications for Intermodal Competition," in *Antitrust Policy Issues*, Patrick Moriati, ed. New York: Nova Science Publishers, Inc., 2006, pp. 157-174, at 171-172.

(such as wireline with wireless services), Zimmerman suggests that cable companies may be the only source of intermodal competition for the RBOCs.[99] Zimmerman suggests that the competition between telephone companies and cable companies will be for bundled offerings, but suggests that regulators must "closely monitor the progression of competition between cable operators and the RBOCs, and implement the appropriate behavioral remedies in order to protect consumers when and if such competition is deemed to be insufficiently vigorous."[100] Zimmerman, like many economists, suggests that it is too early to tell whether the market presided over by "facilities-based regional duopolies" will lead to lower retail prices "or whether it will simply involve two carriers 'splitting' the (monopoly) level of profits between them."[101]

2.5.3. Duopolistic "competition" fails to protect consumers.

Although the FCC determined that wireline broadband is an information service,[102] the cable-telco duopoly does not provide sufficient competition to protect consumers from supracompetitive rates, service quality deterioration, and excessive control by telephone companies and cable companies of consumers' "information pipes." First, for consumers that seek basic plain old telephone service ("POTS") or basic cable as a single non-bundled service, a cable-telco duopoly, where both industries are competing to offer a bundle of voice, data, and video services to their customers, is

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[99] / This paper does not address the alleged intermodal competition in the telecommunications market in an exhaustive manner. However, BOC assertions regarding the abundance of intermodal competition have been rebutted in various proceedings. The New Jersey Board undertook an analysis of the state of competition in New Jersey as part of its investigation of the proposed Verizon/MCI merger. *See*, *NJ BPU Verizon/MCI Merger Order*. In its Order approving the merger, the Board found that intermodal services do not serve as an economic substitute for wireline services in New Jersey's local market for either enterprise or mass market customers. *Id.*, at 33-36. The BPU concluded: "we are not willing to accept on this record that intermodal technologies such as VoIP, WiFi, WiMAX and cable telephony currently constrain Verizon's wireline pricing to a meaningful degree." *Id.*, at 36. The Board further concluded that wireless services were viewed by consumers as supplements, instead of substitutes to Verizon's wireline service. *Id.*

[100] / Paul R. Zimmerman, U.S. Federal Communications Commission, "Strategic Bundling in Telecommunications and its Antitrust Implications for Intermodal Competition," in *Antitrust Policy Issues*, Patrick Moriati, ed. New York: Nova Science Publishers, Inc., 2006, pp. 157-174, at 173.

[101] / *Id. See*, also, William G. Shepherd, *The Economics of Industrial Organization*, 3rd ed., Englewood Cliffs, NJ: Prentice-Hall, Inc., 1990 and Hal R. Varian, *Intermediate Economics: A Modern Approach*, 5th ed., New York: WW Norton & Company, 1999.

[102] / *Wireline Broadband Order*, at paras. 5, 12.

irrelevant.[103] In the regulated monopoly model, regulators could ensure that all segments of society benefit from advanced technology.[104] Under today's deregulatory paradigm, where true competition has not yet arrived, but new services are unregulated, consumers are vulnerable to two distinct harms as the incumbent telephone companies roll out new technology: (1) some consumers will be left behind as the telco-cable duopoly races to attract and to lock in high-revenue customers; and (2) precisely those consumers who are left behind will be forced to subsidize new services.

Even those customers who are willing and able to pay for bundled packages of voice, data, and/or video services confront high transaction costs to migrate from one supplier to another. Transaction costs include the time and financial outlay for service installation, equipment, and an e-mail address change. Moreover, telecommunications service providers use various tactics to lock-in customers. Although some of these tactics may offer short-term consumer benefits, they also impose transaction costs if customers later wish to change service providers. Some of the tactics that deter migration include: offering discounts for one-year contracts, instead of month-to-month agreements; bundling necessary equipment with a long-term commitment; imposing early termination fees, and the non-portability of many features of the service.

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[103] / Verizon will surely seek to provide video services as part of a bundle of services to customers. The experience of cable companies entering the voice market illustrates this point well. The cable offerings are usually more expensive than a single, local wireline connection that low-income or elderly consumers may require. In order to qualify for a rate that is more comparable to a typical wireline rate, cable telephony customers typically must also subscribe to an entire bundle of services they may not need or desire. Even then, the phone service is more expensive than a basic, local line, in part because it usually includes unlimited long distance calling. For example, Cablevision's website indicates that a subscriber cannot buy Cablevision's Optimum Voice product without either subscribing to Cablevision's Optimum Online product or its "Triple Play" offering that includes iO digital cable, optimum online, and optimum voice products. With the "Triple Play" each service is $29.95 a month for the first year (http://www.optimum.com/order/triple_play.jsp accessed January 4, 2007). Comcast digital voice pricing, where available, is $39.95 for Voice in a package with Cable and Internet services; $49.95 for Voice in a package with Cable or Internet services; and $54.95 as a stand-alone product (pricing accessed for Jersey City address on January 4, 2007). Time Warner Cable has similar pricing, offering digital phone for $49.95 if a subscriber has no other services or even just analog cable service (http://www.timewarnercable.com/nynj/products/cable/packagesandpricing.html accessed January 17, 2006). In a recent survey of VoIP customers, eighty percent of cable VoIP customers indicated that they subscribed to VoIP and high-speed Internet access as a bundle. Brian Santo, "Survey: Cable VoIP subs more satisfied than pure-play VoIP customers," *CED*, May 25, 2006, available at http://www.cedmagazine.com/index.asp?layout=articlePrint&articleID=CA6338178.

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

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In addition to the business goal of seeking to attract customers in the high revenue segment of the market, the desire to lower customer churn is one of the industry's key motivating reasons for marketing bundled offerings to customers. The FCC recently stated in reviewing the Verizon/MCI merger:

> Verizon's documents reveal that its research and development, marketing, and corporate strategies focus upon service offerings designed to encourage consumers to subscribe to a local and long distance service bundle. Verizon's incentive is to drive consumers to purchase all telephone services from Verizon to reduce its marketing costs and churn, as well as to increase its average revenue per user.[105]

This lower customer churn ensures that customer acquisition is a higher priority than customer retention and thus "competition" in the market fails to ensure high quality service for existing customers.

Furthermore, it is not evident that the current level of competition between cable companies and telcos is providing market discipline. As noted above, cable prices continue to rise. Similarly, Verizon recently raised its DSL prices. A recent episode illustrates the continued need for regulatory oversight. The FCC determined in 2005 that DSL subscribers would no longer be required to pay into the federal universal service fund ("USF"), and also anticipated that its decision would help spur the deployment of broadband at affordable prices. However, Verizon and BellSouth both opted not to pass those savings on to consumers. Instead, Verizon announced plans in August, 2006 to charge a "supplier surcharge" and BellSouth announced plans to impose a "regulatory cost recovery fee" in the place of the universal service fee.[106] After public outcry and statements by the FCC that it would investigate the actions of the carriers, these two Bells capitulated and announced plans to drop the fees.[107] The episode illustrates why consumer advocates and regulators have important oversight roles and why competition alone does not provide pricing discipline.

In August 2006, Verizon's lowest priced DSL offering (with speeds up to 768 Kbps) was $14.99. However, after dropping its "fee" Verizon apparently simply later

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[105]/ *FCC Verizon/MCI Merger Order*, at note 296. The Commission also stated, "[m]oreover, these strategies are revealed in their marketing." *Id.*, citing, Verizon Second Quarter 2005 Earnings Conference Call at 6, wherein it was stated: "In consumer, our approach to the marketplace is to focus on customer retention and loyalty, while increasing the average monthly revenue per customer through these new services and higher penetration of bundles and packages."

[106]/ Amy Schatz, "Verizon and BellSouth DSL Users Won't See Lower Bills as Fee Ends," *The Wall Street Journal*, page A2, August 22, 2006.

[107]/ Federal Communications Commission, News Release, "Statement of FCC Chairman Kevin Martin on Verizon and BellSouth Eliminating Recently Imposed DSL Fees," August 30, 2006; Verizon, News Release, "Verizon Removes DSL Supplier Surcharge," August 30, 2006.

raised its monthly rates. Verizon is currently offering this service for $19.99.[108] Verizon has been able to sustain a rate increase while, as Figures 4 and 10 show, still attracting and retaining customers.

2.6. The level and type of competition that customers experience vary.

While the telephone and cable companies appear to be poised to compete head-to-head nationwide and in New Jersey, the extent to which each company will enter the other's traditional market (*i.e.*, telephone companies entering the video market and cable companies entering the voice market) will vary. Competition, even duopolistic competition, will vary by product market, geographic market, and customer class.

As the previous section discusses, it is unlikely that telephone and cable companies will compete with each other except in the bundled services market (and even in that market, the duopoly incentive will temper the competition). Not all consumers seek all products. Carriers compete more aggressively to sell lucrative triple-play packages, and, although they may not compete on price, they may compete on the basis of product differentiation. The benefits of competition in the cable market from the telephone companies entering will likely accrue almost entirely to customers of bundled services, with Verizon primarily providing video services as part of a bundle of services. Verizon is unlikely to offer what is traditionally thought of as "basic" cable.

The experience of cable companies entering the voice market illustrates this point well. The cable companies' voice offerings are usually more expensive than a single, local wireline connection. In order to qualify for a rate that is more comparable (yet, still higher than) an average wireline rate, cable telephony customers typically must also subscribe to an entire bundle of services they may not need or desire.[109] A basic cable subscription from the local cable company, with access to local television stations, but no bells and whistles, will probably prove to be less expensive than an IPTV offering. Yet, competition from IPTV may not provide price constraints and the cable company will be able to raise prices for basic service while still undercutting the IPTV price.

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[108] / This rate is introductory and requires a 12-month commitment. Details available at http://www22.verizon.com/content/consumerdsl/plans/all+plans/all+plans.htm (accessed January 16, 2006). AT&T customers in 22 states can now subscribe to DSL at the same speed for only $10.00. AT&T has made the following commitment: "Within six months of the Merger Closing Date, and continuing for at least 30 months from the inception of the offer, AT&T/BellSouth will offer to retail consumers in the Wireline Buildout Area, who have not previously subscribed to AT&T's or BellSouth's ADSL service, a broadband Internet access service at a speed of up to 768 Kbps at a monthly rate (exclusive of any applicable taxes and regulatory fees) of $10 per month." Letter from Robert W. Quinn, Jr., Senior Vice President Federal Regulatory, AT&T to Ms. Marlene H. Dortch, Secretary, Federal Communications Commission, Re: Notice of *Ex Parte* Communications *In the Matter of Review of AT&T Inc. and BellSouth Corp. Application For Consent to Transfer of Control*, WC Docket No. 06-74, December 28, 2006 ("AT&T/BellSouth Merger Conditions").

[109] / *See* footnote 103, supra.

Likewise, the cable company will have the incentive to raise prices for services in rural or poor areas where the telephone company's video offering is not yet available and thus subsidize discounts and offers extended to subscribers in the more competitive regions. Similarly, the phone company will have the incentive to subsidize its video deployment in wealthy areas and to attract the "high value" customer with revenues from noncompetitive services.

Although the addition of a competitor in the cable market is to be applauded, regulators should continue to monitor the market because a cable-telco duopoly is not sufficient to provide effective competition and the telco and cable competitors are indisputably still dominant carriers in their respective non-bundled markets. A range of competition exists across markets and regulators still must address the reality that both cable and phone companies may operate as monopolies in some segments of the market. Chapter 3 addresses the incentives and manner in which carriers are able to cross-subsidize and leverage monopoly positions in their respective traditional markets.

3. INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE INCENTIVE TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

3.1. Introduction.

In a world in which companies increasingly integrate and promote "bundles" of diverse technologies, requirements for accounting and accountability may seem arcane. Indeed, if the product market was competitive, that is, if there were no dominant carriers capable of exerting market power, proposals for accounting and structural separations, and many other regulatory proposals, would be superfluous. However, as this paper demonstrates, a number of the underlying components of the product bundles that Verizon, Cablevision, Comcast, and other cable companies advertise and sell are not yet competitive.

Cable companies are leveraging their unique dominance in the cable television market to offer services that once were the exclusive domain of telephone companies. In turn, Verizon is using its unique dominance in the telecommunications market to offer services that once were the exclusive domain of cable companies. Section 3.2 describes generally the ways in which these industries are entering each others' traditional markets. Because each of these industries relies on substantial shared common resources and plant to enter new markets, and because each industry dominates its respective market in the provision of basic service, significant opportunities for improper cross-subsidization abound.

3.2. Cable and telecommunications companies rely on extensive common resources and facilities to bring both "traditional" and "state-of-the-art" products to market.

That cable and telecommunications companies are seeking to offer more services over their networks is indisputable. Companies like Verizon that traditionally concentrated on voice service first expanded their service offerings to include Internet access over copper wire. The increasing importance of the Internet, consumers' demand for greater speed while online, and the emerging threat from cable companies eventually provided the impetus for telephone companies to deploy fiber optic technology in order to reach the homes and businesses of users more effectively.[110] The increased capacity provided by fiber technology allowed traditional "voice" companies to refocus their

[110] / *See* Appendix 2.

business strategies, first toward data, and now, toward the bundle of voice, data, and television services.

Verizon New Jersey and its corporate parent are providing these new services over plant once used exclusively for voice service and are devoting personnel and resources to these new services, it once focused primarily on intrastate regulated operations. Verizon New Jersey's November 2006 application to the Board for a system wide cable franchise asserted that Verizon New Jersey was "not seeking authority … to construct the FTTP [fiber to the premises] Network, but rather . . . seeking the authority to provide cable television service pursuant to a system wide franchise under N.J.S.A. 48:5A-15."[111] On the other hand, Verizon New Jersey characterized its video deployment as simply an upgrade of "substantial portions of its telecommunications network with FTTP technology as a common carrier," and stated further, "[a]s such, the construction being performed in the public rights of way is being undertaken pursuant to Verizon NJ's authority as a telecommunications service provider."[112] Clearly, in addition to relying on its new fiber network for the rollout of FiOS TV, Verizon also intends to utilize portions of its existing network for the provision of new services.

Likewise, the cable industry once focused exclusively on the provision of television services. However, the ubiquity of the industry's network allowed transformation of the cable infrastructure into a system for providing data service – in particular, access to the Internet – to homes in the existing cable systems' footprint. Today, as the idea of convergence takes hold, the cable industry sees the same opportunity as the telephone companies – the opportunity to provide *all* the telecommunications, information services, and entertainment that households require, and thus maximize its revenue per connection. As Cablevision states in an earnings release, it offers:

> Telecommunications Services includ[ing] Cable Television – Cablevision's "Optimum" branded video, high-speed data, and voice residential and commercial services *offered over its cable infrastructure* -- and its "Optimum Lightpath" branded, *fiber-delivered commercial data and voice services*.[113]

Comcast states that it is "principally involved in the development, management and operation of *broadband cable networks* and in the delivery of programming content."[114] Comcast does not refer to separate networks for video, information, and voice. It is clear the Comcast, and, indeed, most if not all of the cable and telecommunications companies, are sharing resources among business segments.

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[111] / Verizon Franchise Application, at 9.

[112] / *Id.*, at 18.

[113] / Cablevision Systems Corporation, "Cablevision Systems Corporation Reports Third Quarter 2006 Results," November 8, 2006, at 2 (emphasis added).

[114] / Comcast Corporation, "presskit_121506.pdf," available at www.comcast.com, at 1 (emphasis added).

3.3. Implications for consumers.

The implications of shared resources and facilities for consumers are far reaching. Consumers of one service, for example, basic telephone service, are implicitly financing the expansion of the telco business to support video. Similarly, the customer of basic cable television service is supporting the technology development, marketing, and administration of voice service over the cable facilities. Although the additional cost may be obscured from most individual consumers, the aggregate effect over all consumers is enormous.

In addition to the fact that consumers are forced to pay for services that many do not receive (either because products are unavailable in their area, they cannot afford the product, or do not want the product), the implicit subsidization removes important economic signals from the market. Basic business economics suggests that a project is worth undertaking only if it pays for itself. And yet, Verizon New Jersey states that financing for its cable offering comes from "internally generated funds."[115] This suggests that financing to deploy and promote video service comes from its base of traditional customers, many of whom will never benefit from Verizon video offerings. Instead, stockholders should be bearing the risk for new ventures. The same concern applies to cable's foray into voice service. The key question is, "Who is paying for this new service?"

3.4. Verizon recently obtained statewide franchising authority.

On December 15, 2006, the Board approved Verizon New Jersey's application and granted Verizon New Jersey the state's first systemwide cable television franchise,[116] made possible by legislation enacted in August 2006.[117] Prior to this legislation, companies intending to provide cable service were required to negotiate franchise rights with each municipality on an individual basis. The legislation paved the way for Verizon to seek authority to offer cable services to 316 municipalities throughout the state.[118]

Among other things, as noted by the Board, Rate Counsel "had a number of factual questions as to the information provided by the applicant, including . . .

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[115] / Verizon Franchise Application, at 22.

[116] / *Verizon Systemwide Cable Television Franchise Order*.

[117] / On August 4, 2006, Governor Corzine signed cable franchise legislation A-804/S-192. State of New Jersey Office of the Governor, Press Release, "Governor Corzine Signs Cable Franchise Legislation and Executive Order," August 4, 2006.

[118] / New Jersey Board of Public Utilities, "New Jersey Board of Public Utilities Approves First Systemwide Cable Franchise in the State," available at http://www.bpu.state.nj.us/home/news.shtml?44-06.

interaction between the regulated telephone business entity and the cable operating business entity."[119] The Board determined that the legislation did not enable the Board to grant a provisional franchise, as recommended by Rate Counsel, but stated that:

> The Board intends, however, to condition any grant of a franchise on appropriate and necessary conditions that must be met for VNJ to remain in compliance with the franchise, and it is the Board's belief that this approach both satisfies the legal mandate provided to the Board and allows for the type of continuing oversight that the Public Advocate, as well as the Board, considers proper for this or any other franchise, and which is in keeping with past Board action.[120]

The Board also addressed the federal requirement that cable service providers be exempted from rate regulation if a local exchange carrier offers video services in the franchise area of an unaffiliated cable operator. The Board stated that it "is aware that VNJ is subject to effective competition," and that "[t]here would be no value, and it would require the Board to ignore the basic facts, for the Board to assert rate regulation over VNJ."[121] However, as Chapter 2 demonstrates, contrary to the Board's discussion, the presence of an incumbent cable operator does not provide sufficient competition. Therefore, structural separations, clear accounting, and regulatory oversight of Verizon NJ's allocation of costs to its cable operations are essential. Neither the legislation nor the Board's Order address the significant opportunity for improper cross-subsidization created by Verizon's entry into the cable business.

3.5. Verizon New Jersey's FiOS application.

Verizon New Jersey's cable franchise application provides some detail about its plans for video deployment in New Jersey, but asserts that many important details regarding its plans, particularly those related to identification of particular communities planned for deployment, are confidential.[122] In its application, Verizon states that it intends to begin providing commercial cable television service to some of the municipalities listed in Exhibit B (a confidential exhibit not included in the public version of Verizon's application) within three years of the date of issuance of a systemwide cable franchise in New Jersey. The company plans to make cable television service available throughout all of the municipalities listed in the confidential exhibit within six years of issuance of the franchise.[123]

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[119] / *Verizon Systemwide Cable Television Franchise Order*, at 5.

[120] / *Id.*, at 9.

[121] / *Id.*, at 14. *See*, also, *Id.*, at 13, citing 47 C.F.R. §79.905.

[122] / As noted in the *Verizon Systemwide Cable Franchise Order*, at footnote 2, the Division of Rate Counsel has been provided the full non-redacted application under a confidentiality agreement in Docket No. CE06110768. This paper relies on the redacted version of the Application.

[123] / Verizon Franchise Application, at 1.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE INCENTIVE TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

Verizon Communications is pursuing cable television franchises in many communities throughout the country. At the time of the Application, Verizon held 190 cable franchises covering approximately three million households in New York, Virginia, Maryland, Texas, Massachusetts, California, Florida, Pennsylvania, and Delaware. FiOS TV is currently available to approximately 100 communities in Verizon's operating territory. Verizon reports that the average penetration rate for FiOS TV after six months of marketing is approximately ten percent.[124]

As previously noted, Verizon describes its application as "not seeking authority … to construct the FTTP Network, but rather … seeking the authority to provide cable television service pursuant to a system wide franchise under N.J.S.A. 48:5A-15."[125] Verizon further cites section 15 of the systemwide franchise legislation (*N.J.S.A*. 48:5A-15), stating: "telecommunications service providers currently authorized to provide service do not require approval to upgrade their facilities that may be used in connection with the provision of cable television service."[126]

Verizon's application characterizes the fiber used to provide cable television service as single mode cable with 12 to 864 fibers,[127] and states that its service will be delivered to the premises via the FTTP telecommunications network.[128] Although the application requires a map showing the proposed service area of the franchisee, Verizon states that inclusion of such a map is unnecessary because the FTTP facilities being utilized are authorized under Title II of the Communications Act and Chapter 17 of New Jersey's *N.J.S.A*. 48:1.2 et seq. Nevertheless, the company provides a list of affected municipalities in Exhibit N to its Application, which it deems to be confidential.[129]

Verizon refers to Confidential Exhibit R to its application for details concerning financing of the rollout of FiOS TV service. This exhibit also purportedly provides projections of revenues, cash flow, and expenditures. However, the company later explains that it "intends to finance the construction of the FTTP system and the provision of cable services through a variety of internally generated funds."[130]

Based upon Rate Counsel review, the information that Verizon provided to the Board does not include sufficient information to enable the Board to detect and to deter improper cross-subsidization. As Rate Counsel stated, "[t[hese rules must propose and include sufficient safeguards to preclude cross subsidization of services and appropriate

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[124] / *Id.*, at 8.

[125] / *Id.*, at 9.

[126] / *Id.*, at 18.

[127] / *Id.*, at 15.

[128] / *Id.*, at 16.

[129] / *Id.*, at 15.

[130] / *Id.*, at 22.

safeguards that ensure the continued safe, and adequate cable service for New Jersey residents at just, reasonable, and affordable rates."[131]

3.6. Structural separations is needed to prevent Verizon from deploying video and other new services "on the backs of" consumers.

3.6.1. Verizon's and the cable industry's access to a ubiquitous network of customers gives them ample opportunity to engage in improper cross-subsidization.

The Bells' DSL deployment shows that incumbents possess the incentive and ability to assign and allocate common costs to consumers and to retain revenues for shareholders. Verizon's successful DSL sales yield the company substantial profits, in large part, because, as a result of the under-assignment of common costs to this line of business, DSL gets a "free ride" over the basic loop component of Verizo's ubiquitous copper network. More generally, basic services are a "cash cow" to fund Verizon's forays into new lines of business.

Table 2 shows that Verizon generates between $100,000,000 and $500,000,000 per year from its DSL operations in New Jersey.[132] However, Verizon likely assigns and allocates minimal costs of common plant and resources to this line of business. The consequence of this revenue-cost mismatch is that shareholders benefit from high profits, and consumers of basic services pay high rates.

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[131] / Remarks of Seema M. Singh, Esq., Director, Division of Rate Counsel presented by Christopher J. White, Esq., Deputy Public Advocate, *In the Matter of the Board's Regulation of Cable Television, Proposed Readoption with Amendments: N.J.A.C. 14:18 and Proposed New Rules: N.J.A.C. 14:18-14 and 15*, Docket Nos. CX06030141 and CX06080580, Proposal Number: PRN 2006-384, Public Hearing, Board of Public Utilities, Newark, New Jersey, January 4, 2007.

[132] / Data on Verizon New Jersey's DSL customer base and revenues are not publicly available. Because Verizon New Jersey serves the vast majority of New Jersey, Table 2 relies, for one estimate, on the total number of DSL connections for New Jersey reported in the FCC's High-Speed Services July 2006 Report, at Table 11 as a proxy for the number of connections provided by Verizon New Jersey. As of December 31, 2005, this number was 540,382. The second estimate is based on the fact that Verizon's switched access lines in New Jersey represent 11.3% of all of Verizon's switched access lines. The ratio of 11.3% is multiplied by total Verizon DSL connections as of September 30, 2006. (Sources: Total Verizon Switched Access Lines: Verizon Communications, Investor Quarterly: VZ Q4 2005 Investor Quarterly, page 13; Verizon New Jersey Switched Access Lines: FCC, Selected RBOC Local Telephone Data, as of December 31, 2005; Total Verizon DSL Connections: Verizon Q3 2006 Investor Quarterly, page 14; Monthly DSL Rates: Verizon website (http://www22.verizon.com/content/consumerdsl/plans/all+plans/all+plans.htm and http://www22.verizon.com/content/businessdsl/packages+and+prices/packages+and+prices.htm), accessed 1/15/2007.))

Table 2
DSL Generates Substantial Revenue for Verizon New Jersey
(Annual)

	Monthly Rates		Annual VNJ DSL Revenues	
Number of Connections	Lowest Rate	Highest Rate	Low Estimate	High Estimate
540,382	$19.99	$59.99	$129,626,834	$389,010,194
739,761	$19.99	$59.99	$177,453,869	$532,539,149

Note: This table includes two estimates of the total number of DSL connections. The first estimate corresponds with all DSL connections in New Jersey as of December 31, 2005. The second estimate is based on Verizon's company-wide DSL lines as of September 30, 2006 and an estimate of New Jersey's share of those lines. The number of DSL connections is multiplied by the highest and lowest advertised monthly rates, times 12, to arrive at estimates of annual DSL revenue for Verizon New Jersey.

3.6.2. Verizon's FiOS venture may prove profitable in the future, however, the Board should determine whether the "internally generated funds" Verizon is currently using to finance its FiOS business venture are coming from regulated operations.

Verizon began rollout of its FiOS fiber network in 2004, and by the end of 2005, the network passed 3 million homes in 800 communities.[133] As of the end of the third quarter of 2006, Verizon's FTTP network passed a total of 5.3 million homes. Furthermore, Verizon has seen a steady increase in demand for the products that it provides over the FiOS network. As of the third quarter of 2006, penetration rates for FiOS Internet service and FiOS TV reached 14%, and 10%, respectively.[134] FiOS Internet customers totaled 522,000 at the end of the third quarter of 2006 and FiOS TV customers totaled 118,000.[135]

Verizon added 448,000 net new broadband connections in the third quarter of 2006 for a total of 6.6 million broadband connections, an increase of 45.1% from the third quarter of 2005.[136] FiOS Internet customers represented 147,000 of the net new

[133] / Verizon 2005 Annual Report, at page 6.

[134] / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at page 5.

[135] / *Id.*, at page 3.

[136] / *Id.*, at 2.

broadband connections in the third quarter and as of the end of third quarter 2006, Verizon reported 522,000 FiOS Internet customers. Additionally, Verizon reported 118,000 FiOS TV customers at the end of the third quarter of 2006.[137]

Verizon clearly views this as just the beginning of the FiOS era. A Verizon executive told Wall Street analysts in September 2006:

> We will meet our 6 million [homes passed] objective by the end of the year. We will open 5 million premises for sale on the data side . . . You can see the end-of-period [year 2010] objective there -- 18 million homes passed. And also, that would be about 50% of our households.[138]

Verizon predicted that it will achieve 35-40% penetration of the households passed by their FiOS network for data, and 25% penetration for video, by 2010.[139]

Although Verizon's video deployment is still in the early stages, it appears to have already achieved notable success. Verizon began offering video service over FiOS in three markets in 2005. The Keller, Texas area was the first FiOS video market, and the video penetration rate was 21% after only four months.[140] Before entering New Jersey markets, Verizon counted more than 230 franchise areas, covering approximately 5 million households in 10 states.[141] Verizon estimated a 10% penetration rate for its FiOS TV offerings across all of its markets.[142]

Table 3 summarizes Verizon's present rates for its FiOS-based services. Although FiOS offers speeds much faster than the speed of its DSL service, the FiOS rate is also much higher than DSL rates. As Table 3 shows, consumers pay $39.95 for stand-alone FiOS-based access to the Internet. By comparison, Verizon's DSL-based Internet is $19.95,[143] and AT&T's new DSL rate is $10.00.[144]

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[137] / *Id.*, at 3.

[138] / Verizon FiOS Briefing Session, at page 4.

[139] / *Id.*, at page 11.

[140] / Verizon 2005 Annual Report, at page 15.

[141] / Verizon News Release "TV as You've Never Seen It Before: Verizon Launches FiOS TV in Greater Philadelphia Area," December 4, 2006.

[142] / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at 5.

[143] / *See* Appendix 2.

[144] / *AT&T/BellSouth Merger Conditions.*

Table 3
Rates for FiOS Services

FiOS Internet Service		
	Monthly Rates	
For Internet Access Speeds Up To: (downstream/upstream)	Stand-Alone	Part of a Package
5 Mbps/2 Mbps	$39.95	$34.95
15 Mbps/2 Mbps	$49.95	$44.95
30 Mbps/5 Mbps	$199.95	$179.95

FiOS TV Premier Package	$42.99
Set Top Box Options	
Standard Definition	$4.99
High Definition, with HD Channels	$9.99
Dual-tuner, HD-Capable Digital Video Recorder	$12.99

FiOS Bundle	
FiOS TV, FiOS Internet, and Verizon Freedom Value Unlimited Calling Plan	$104.85

Sources: Verizon New Jersey website (http://www.verizonnj.com /fttp/NJ/Verizon_FiOS_Fact_Sheet.asp); Verizon News Release, "TV as You've Never Seen It Before: Verizon Launches FiOS TV in 106 New Jersey Communities," January 11, 2007; Verizon News Release, "Verizon FiOS TV Comes to Lynn, Marlborough and Needham, Mass.," December 12, 2006.

Although Verizon is successfully selling its FiOS-based services, FiOS is not yet profitable. Verizon Chief Financial Officer and Executive Vice President Doreen Toben stated "[w]e believe FiOS will result in sustainable profit growth for the business for years to come."[145] She explained further that FiOS should reach positive EBITDA in its third year and positive operating income in its fourth year.[146]

The enormous development and deployment costs of FiOS presently act as a drain on Verizon's income. Wireline offerings (both voice and data) and Verizon's FiOS

[145] / Verizon FiOS Briefing Session, at page 3.

[146] / *Id.*, at page 25.

(Internet and TV) offerings are served out of the "Verizon Telecom" business unit.[147] In the third quarter of 2006, for example, Verizon's income dilution from FiOS data and video deployment was 9 cents per share. The full year estimate from this dilution was increased in the third quarter of 2006 from 28 to 30 cents per share to 31 to 32 cents per share.[148] There were approximately 2.9 billion shares at the end of Q3 2006,[149] which means the earnings dilution for 2006 is approximately $900 million.

Verizon's ambitious goal of running fiber to the premises is a costly endeavor.[150] According to Verizon executives, over seven years, the cost of deployment is expected to be approximately $22.9 billion. On a per home basis, this will average $817 to pass (running the fiber to the premises); $172 for development of the video network; and $718 to connect (making the physical connection of the premises to the network).[151] Verizon indicates, however, that the cost to run fiber to the home is reduced by the avoidance of running copper, which, according to Verizon, reduces the total deployment cost to about $1,400 per home passed, or about $2,500 per home connected.[152] Table 4 summarizes Verizon's estimates of its costs of its FiOS rollout.

Table 4
FiOS Rollout Costs Are Declining, But Still Substantial

	Cost To Pass	Cost To Connect
December 2005 (actual)	$1,021	$1,200
September 2006 (actual)	$845	$900
2010 (goal)	$700	$880

Sources: Thomson StreetEvents, Conference Call Transcript, Verizon FiOS Briefing Session, Sept. 27, 2006; Verizon *Investor Quarterly*, Third Quarter 2006, October 30, 2006, at page 5.

Furthermore, Verizon is pursuing the Cadillac fiber deployment plan. In comparison with Verizon's plan (which one article estimates to be $18 billion over six

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[147] / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at 3.

[148] / *Id.*, at page 5.

[149] / *Id.*, at page 7.

[150] / By contrast, AT&T is opting for a far less expensive option of deploying fiber to the neighborhood. "Whitacre's Way," Dennis Kneale, *Forbes*, January 8, 2007, at 84-88.

[151] / Verizon FiOS Briefing Session, at page 24.

[152] / *Id.*, at page 24.

years to cover 18 million homes by the year 2010, "digging up trees and tulips to lay fiber to each and every home"), AT&T is estimated to spend only $4.6 billion to reach 19 million homes by 2008 by bringing fiber into neighborhoods and relying on existing copper phone lines for the last "leg" to households.[153]

Although the decision to deploy a costly fiber network clearly resides with Verizon management, the responsibility to ensure that consumers are not bearing the risk or cost of Verizon's decision resides with the Board. Without adequate safeguards, consumers will bear the brunt of Verizon's ambitious capital investment. Furthermore, the FiOS plans can harm consumers as employees shift their focus from the more mundane task of providing basic telephone service to the deployment of new services and the sales, marketing, customer service, and technical needs related to those services. Board oversight of quality of service has become more important than ever.[154] Furthermore, without comprehensive accounting by Verizon, the Board cannot ascertain whether FiOS would be profitable if Verizon assigned and allocated a fair share of common resources and plant to this new line of business.

3.7. Verizon's bundling strategy now encompasses DSL-based and FiOS-based platforms, which depend critically on resources shared with its local operations.

The Bells' increasing focus on broadband and video increases the incentive for cross-subsidization of new ventures with monopoly revenues. The pattern with DSL is instructive as one considers the implications of Verizon's entry into cable business. In 2000, DSL connections comprised only 1% of total connections nationwide (where total connections are defined as the sum of switched access lines and DSL connections). By 2005, this "DSL ratio" reached 12%.[155] The ultimate penetration of DSL depends on Bell's deployment plans, customer preference for alternative technologies (*e.g.,* cable modem),[156] and the Bells' success in encouraging DSL customers to migrate to the Bells' new fiber-based alternatives.

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[153] / "Whitacre's Way," Dennis Kneale, *Forbes*, January 8, 2007, at 86. *See* generally, 84-88.

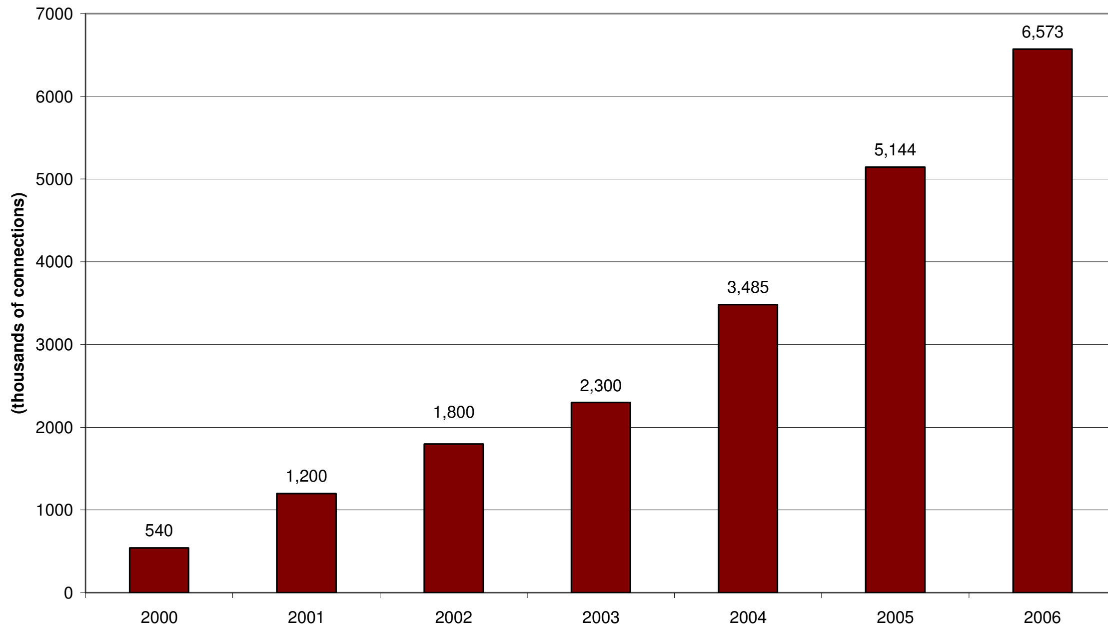
[154] / *See* Section 3.10 following.

[155] / Switched Access Lines: ARMIS Report 43-08, Table III. "Access Lines in Service by Customer," Row 910. DSL Connections: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; Qwest 2002 Annual Report, page 37; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13.

[156] / According to the FCC's latest high speed services data, consumer DSL subscriptions grew by 5.7 million lines in 2005 compared to a growth of 4.2 million lines for consumer cable subscriptions. The cable industry percentage of high-speed lines dropped 3.5%, while the DSL share of high-speed lines grew 3.3% to reach 40.5%. *FCC High-Speed Services July 2006 Report*, at 2.

The following bar chart shows the growth of Verizon's DSL customer base over seven years.

Figure 4
Demand for Verizon DSL Increased More than 1,000% in Six Years



Note: Figures are nationwide in scope. Sources: Verizon Q4 2000 Investor Quarterly, page 5; Verizon Q4 2002 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13; Verizon Q3 2006 Investor Quarterly, page 2.

DSL may be Verizon's strategic stepping stone to other platforms to support its entry into video services, which it seeks to offer in "competition" with cable companies.[157] By locking in customers to DSL-based services, Verizon can then more easily encourage the same customers to migrate to higher-revenue fiber-based video offerings. Proper cost accounting is essential to ensure that Bells compensate customers of local intrastate regulated services adequately for the invaluable use of their embedded customer base. Verizon's ability to offer DSL depends critically on its ubiquitous local loop infrastructure. Verizon's ability to offer cable depends critically on its historic status as the state's incumbent local exchange carrier, and associated infrastructure, corporate resources, and expertise. Furthermore, the FCC's decision to decline to require Verizon and other Bells to provide unbundled fiber to competitors[158] is another reason that Verizon should conduct its new lines of business separately from its intrastate regulated operations.

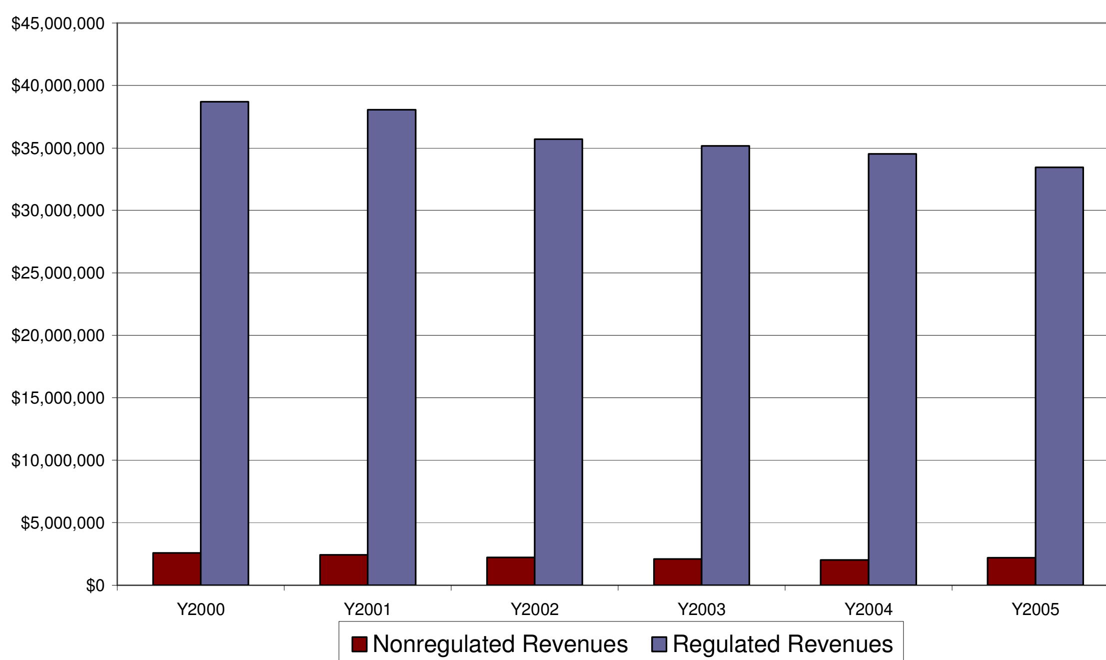
[157] / The purported "competition" is negligible since consumers confront a cable-telco duopoly.

[158] / *Wireline Broadband Order*, at para. 87.

3.8. Verizon enjoys a substantial stream of revenues from noncompetitive services, which provide a virtually risk-free source of monies to enter new lines of business.

Verizon's noncompetitive services provide a substantial, steady stream of revenues. Figure 5 shows that Verizon derives substantial revenues from its regulated operations, which provide it with a substantial opportunity and incentive to cross-subsidize improperly its multi-billion dollar FiOS deployment and its entry into the cable business.[159]

Figure 5
Revenues from Verizon's Regulated Services Are at Risk of Funding Verizon's New Products



Source: FCC ARMIS Report 43-01, Table I, Rows 1045 and 1090, accessed 1/15/1007.

The substantial stream of revenues shown in Figure 5 is especially important given the costly nature of FiOS deployment. Although FiOS is expected to become a cash cow for Verizon, it consumed approximately $900 million of Verizon's cash in

[159] / The magnitude of the unregulated revenues is largely unchanged over the six-year period depicted in Figure 5, which suggests that the category may not include its growing DSL revenues and, furthermore, that more comprehensive cost accounting reports to the FCC may be necessary.

2006.[160] Access to the revenues from its regulated operations and its enviable ranking as the second largest telecommunications company in the country provide Verizon with the opportunity to cross-subsidize new ventures. In many areas, including New Jersey, Verizon has a near monopoly on local service. As Chapter 2 describes, Verizon dominates New Jersey's local markets.

3.9. Improper cross-subsidization harms consumers by distorting rates.

Firms that offer both noncompetitive and competitive services possess the economic incentive to cross-subsidize the services that confront relatively more competition with those that confront minimal or no competition. The cross-subsidization can take the form of misaligned prices: firms have the incentive to over-price monopoly services because customers have little recourse, and to under-price services which face relatively more competitive pressure, in order to attract and retain customers who might otherwise migrate to alternative suppliers. The cross-subsidization can also take the form of selective levels of service quality, with a firm devoting disproportionate resources to the service in the relatively more competitive market.[161] Finally, directly related to the mis-aligned prices, carriers can under-assign and under-allocate costs to the more competitive products, and recover joint and common costs disproportionately from the monopoly offerings.

Although the focus of this paper is on telco-cable cross-entry, even within the telecommunications market, Verizon can exercise its market power to cross-subsidize products. For example, Verizon offers unlimited Directory Assistance ("DA") as part of its bundled offerings, but charges on a measured basis to all other residential customers.[162] Similarly, Verizon charges monthly rates ranging between $2.30 and $4.59 for custom calling services, but includes these same features with no explicit charge as integral components of its "Freedom" packages.[163] The bundled offerings seek to attract

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160 / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at pages 5 and 7.

161 / For example, Verizon told Wall Street analysts in October 2006: "Our goal is to offset FiOS expenses with reductions in the core business . . . Going forward, we continue to see significant opportunities for wireline cost savings. VZ – Q3 2006 Verizon Earnings Conference Call, October 30, 2006, Thompson Financial, Final Transcript available at http://investor.verizon.com/news/20061030/3q06_vz-transcript.pdf, at 3.

162 / Rate Counsel has raised the issue of unlimited DA being provided in Freedom packages in the Board's pending investigation of the classification of DA. *In the Matter of the Board's Review of the Classification of Verizon New Jersey's Directory Assistance Services ("DAS") as Competitive and Associated Service Quality; In the Matter of the Filing of Verizon New Jersey Inc. for the Reclassification of Existing Rate Regulated Services – Directory Assistance Services as Competitive Services*, BPU Docket Nos. TX06010057; TT97120889.

163 / Custom Calling Services include Speed Dialing, Three-Way Calling, Call Forwarding, Talking Call Waiting and Call Waiting. Verizon New Jersey, Inc. Tariff B.P.U.-N.J. No. 2 Exchange and Network Services, Tenth Revised page 59, Issued October 22, 2004, Effective November 22, 2004.

customers whose demand is more price elastic and who are more likely to migrate to cable companies. As another example, Verizon's successful DSL sales (see section 3.6.1 above and Appendix 2) yield the company substantial profits, in large part, because, as a result of the under-assignment of common costs to this line of business, DSL gets a "free ride" over the basic loop. Without a reckoning of the allocation of Verizon's shared and common costs among services, one cannot detect whether basic services are cross-subsidizing services that confront relatively more competition. In the context of cable franchising regulation, the issue is the degree of cross-subsidization of entry into cable businesses.

Similarly, as cable companies in New Jersey seek to break into the telephone market, traditionally supplied by Verizon, they have the incentive to use monies from traditional cable products to cross-subsidize their new telecommunications ventures.

3.10. Improper cross-subsidization harms consumers through the deteriorating quality of basic service.

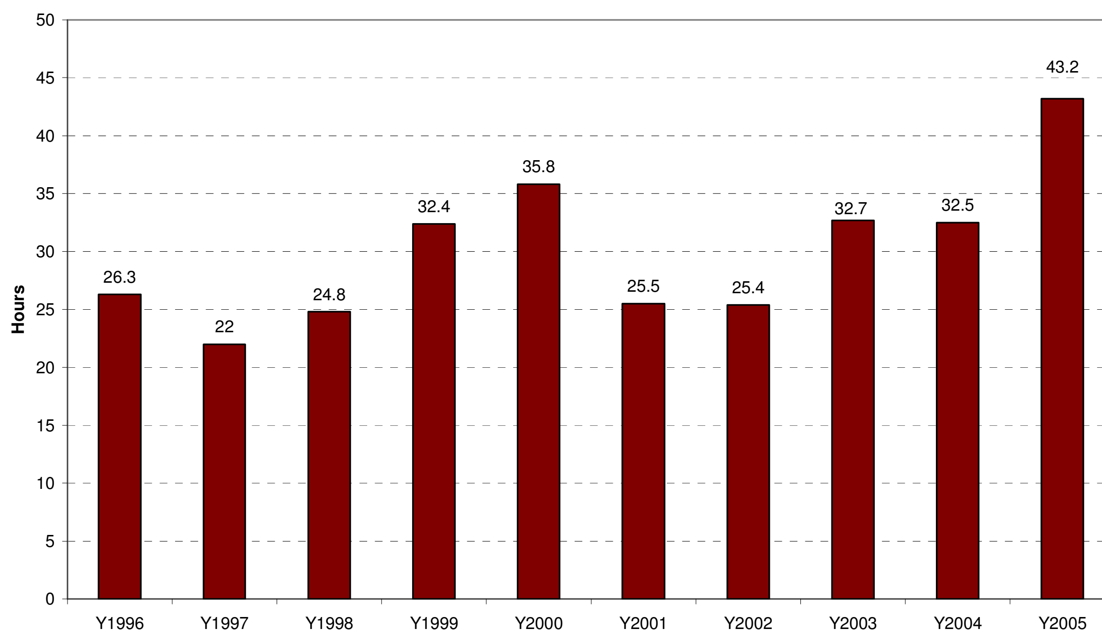
3.10.1.1. Cable and FiOS plans will likely exacerbate the deterioration of Verizon New Jersey's basic telephone service quality.

Verizon and the cable industry possess the economic incentive and the opportunity to offer higher quality of service to customers of new, unregulated products than to customers of regulated and/or noncompetitive products. Specifically, corporate management has the incentive to allocate resources to the triple and quadruple play customers rather than to customers of basic telephone and basic cable service.

Figure 6 shows that the quality of basic telephone service, as measured by the timeliness of Verizon's repair of basic dial tone service, has deteriorated in recent years in New Jersey. The "Initial Out-of-Service Interval" refers to the average duration (in hours) that a customer must wait for telephone service to be restored when there is a service outage: the longer the wait, the worse the performance. The following figure shows that Verizon New Jersey's Initial Out-of-Service Interval lengthened in recent years, reflecting a decline in service quality: The 2005 figure, at 43.2 hours, is almost *twice* the 1997 figure.[164]

[164] / FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 145, Accessed 1/12/2007. The most recent period for which ARMIS data is available is year-end 2005.

Figure 6
Verizon New Jersey's Service Quality Is Declining
(Initial Out-of-Service Interval: Residential Customers)

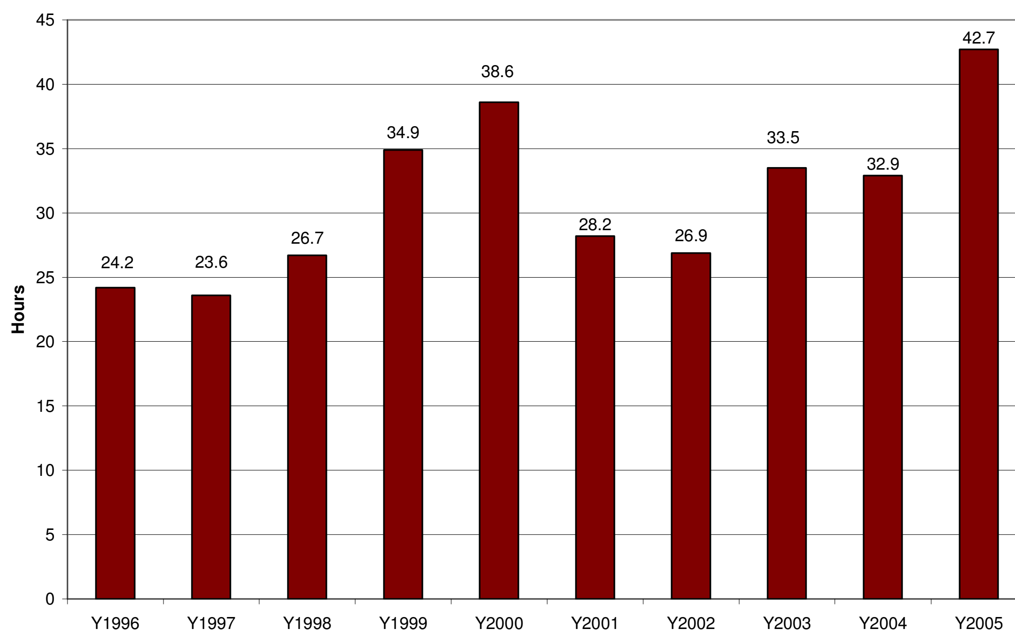


Source: FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 145, Accessed 1/12/2007.

Analysis of "Repeat Out-of-Service Intervals" for Verizon New Jersey shows a similar deterioration of basic telephone service quality over time. The Repeat Out-of-Service Interval refers to the length of time it takes for the telephone company to repair basic service that had an initial unsuccessful repair attempt. Figure 7 shows that the average Repeat Out-of-Service Interval in 2005, at 42.7 hours, was almost 60% longer than just three years earlier.[165]

[165] / FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 149, Accessed 1/12/2007.

Figure 7
Verizon New Jersey's Service Quality Is Declining
(Repeat Out-of-Service Interval: Residential Customers)



Source: FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 149, Accessed 1/12/2007.

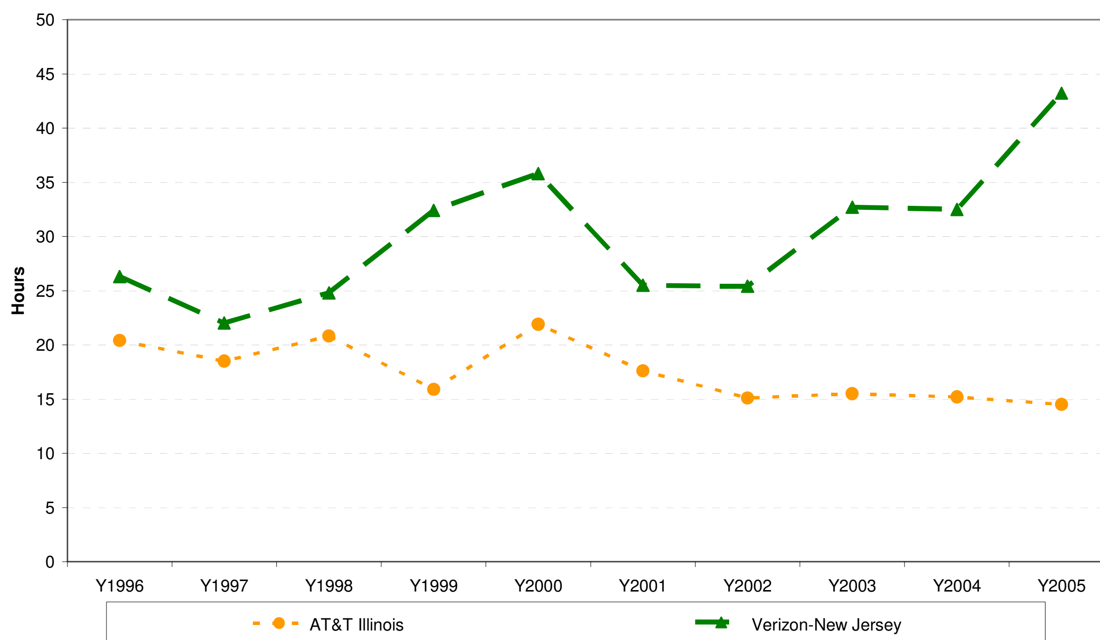
Sufficient competition in the basic local exchange market does not exist to yield adequate service quality. Furthermore, as Verizon diverts corporate attention and field personnel to its FiOS and cable business, service quality will likely deteriorate further.[166] Therefore, safeguards are essential to protect consumers from the improper subsidization of new services with resources that should be assigned to basic regulated ones.

[166] / As Chapter 1 indicates, Verizon's planned sale of its landline business in the three northern New England states provide further evidence of the vulnerability of non-FiOS customers to Verizon's corporate focus on new lines of business. In Maine, New Hampshire, and Vermont, FairPoint Communications Inc. (the company that intends to purchase Verizon's operations) considers itself a "rural, small-urban focused company" and considers northern New England customers its "bread and butter customers." "Verizon to sell lines in N.H., Vt., and Maine," Carolyn Y. Johnson, *Boston Globe*, C1, January 17, 2007, quoting Walt Leach, executive vice president of corporate development for Fairpoint. By contrast, in New Jersey, rural communities' needs will likely take the back seat to Verizon's FiOS focus. Furthermore, Verizon's efforts to obtain further deregulation of its noncompetitive services will exacerbate this issue further. *See, e.g.*, *In the Matter of the Board's Investigation Regarding the Reclassification of Competitive Local Exchange Carrier (CLEC) Services as Competitive,* New Jersey Board of Public Utilities Docket No. TX06120841, Joint Direct Testimony of William E. Taylor and Paul B. Vasington, on behalf of Verizon, January 9, 2007.

3.10.2. Financial accountability creates an incentive for adequate service quality, even where competitive pressures are lacking.

By way of comparison, as Figure 8 and Figure 9 show, based on the same two metrics, and over the same period of time, AT&T's service quality in Illinois exceeds that of Verizon's in New Jersey. The service quality gap has widened over time: Verizon New Jersey's response time to repair requests was both shorter and more in line with that in Illinois in the mid-to-late 1990s than it is today.

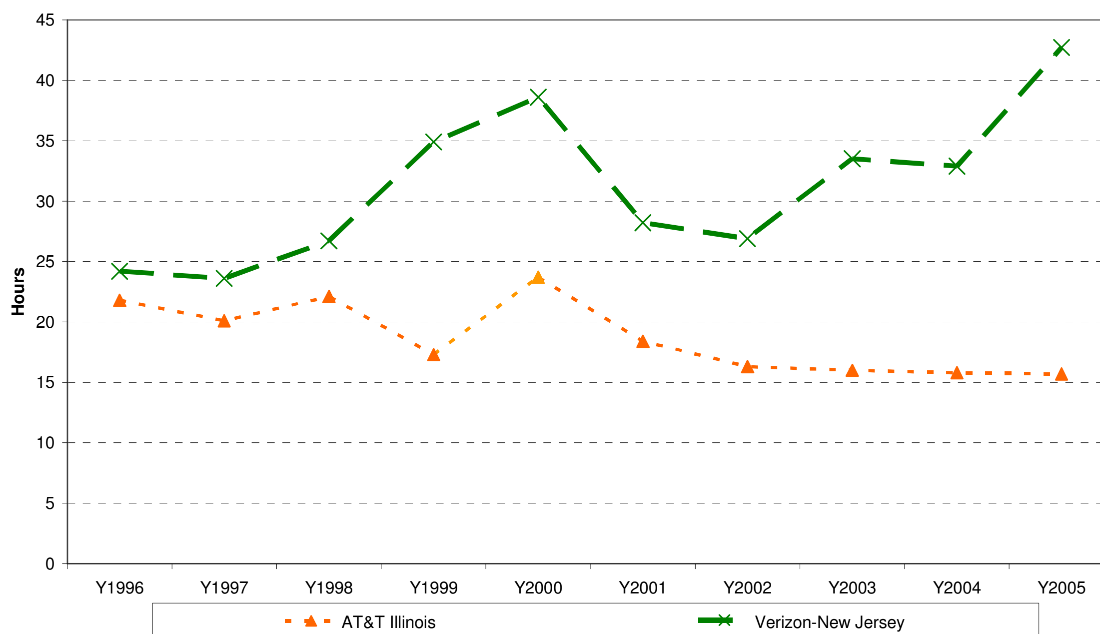
Figure 8
AT&T in Illinois Outperforms Verizon in New Jersey
(Initial Out-of-Service Interval: Residential Customers)



Source: FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 145, Accessed 1/12/2007.

Figure 9 shows a similar pattern of inferior service quality in New Jersey relative to Illinois, as measured by customers who have repeat problems on the same line. The evidence suggests that Verizon New Jersey is allocating insufficient resources (*e.g.*, field technicians) to provide service for its base of traditional telephone customers. As Verizon continues to pursue the cable business, its financial incentives will continue to jeopardize basic telephone service quality.

Figure 9
AT&T in Illinois Outperforms Verizon in New Jersey
(Repeat Out-of-Service Interval: Residential Customers)



Source: FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 149, Accessed 1/12/2007.

A long history of financial incentives for providing adequate service quality may explain the better service quality that Illinois households receive relative to their counterparts in New Jersey. An integral component of the original price cap plan that governed Ameritech - Illinois (now AT&T), approved by the Illinois Commerce Commission in 1994, was a service quality offset of as much as two percentage points a year to the "X" factor if the company failed to meet all of its service quality performance standards.[167] Several years later, as a result of state-enacted legislation, telecommunications carriers were directed to provide customer credits for (1) out-of-service over 24 hours; (2) installation occurring after five days; and (3) missed appointments.[168] By comparison, Verizon New Jersey has not had and continues to lack a compelling financial incentive to maintain and/or improve its service quality.

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[167] / *Petition to Regulate Rates and Charges of Noncompetitive Services Under an Alternative Form of Regulation,* Illinois Commerce Commission Docket No. 92-0448/93-0239 Consol., rel. October 11, 1994, at 56-59.

[168] / 83 Ill.Adm. Code 732, effective August 1, 2001; Illinois Commerce Commission, Docket No. 98-0252, Illinois Bell Telephone Company Application for review of alternative regulation plan; Docket No. 98-0335, Illinois Bell Telephone Company petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates; Docket No. 00-0764, Citizens Utility Board and the People of the State of Illinois -v- Illinois Bell Telephone Company, Verified Complaint for a Reduction in Illinois Bell Telephone Company's Rates and Other Relief, Order, December 30, 2002, at 196.

3.10.3. Verizon's experience in New York is instructive.

The conflict in New York between FiOS and plain old telephone service is instructive of the likely conflict brewing in New Jersey between new and old services. In New York, where Verizon has been rolling out FiOS, the Public Service Commission faulted Verizon for failing to provide adequate service and raised the possibility of penalties.[169] In a report submitted to the New York Public Service Commission, Staff noted deficiencies in seven of 35 service repair bureaus. Among other things, the Commission Chairwoman, Patricia L. Acampora, observed that "the Commission is obligated by law to ensure adequate service quality for those customers who rely on Verizon's copper network for their telephone service."[170] Similarly, the Board continues to have oversight of the adequacy of Verizon NJ's service quality, and, therefore, of the degree to which Verizon's pursuit of new services jeopardizes its ability to provide adequate phone service over copper lines. The New York Public Service Commission stated the following about Verizon's possible neglect of its copper network while it pursues the deployment of its FiOS network:

> We recognize Verizon needs to reconfigure its network in order to remain a viable service provider in the long term and its fiber strategy is an aggressive move in that direction. Nonetheless, the company also must concentrate adequate resources to satisfy all of its existing customers' service quality needs as determined by our Service Standards and meet its obligation under Public Service Law to provide adequate service. Public safety and network reliability remain paramount, in our view, regardless of the technology used to provide telecommunications services. We remain concerned about Verizon's ability to develop and implement service improvement plans to improve timeliness of repair performance given the deployment of a fiber network while most consumers continue to be served via the existing copper network. With minimal investment, the copper network is aging and, in all likelihood, could show signs of increasing trouble reports that may overwhelm the company's ability to repair out-of-service conditions in a timely manner statewide, rather than just a few selected locations that we will address shortly.[171]

[169] / "PSC raps Verizon service in some areas," Mark Johnson, *The Boston Globe*, January 8, 2007, http://www.boston.com/business/articles/2007/01/08/psc_raps_verizon_service_in_some_areas/

[170] / New York Public Service Commission Press Release, "Verizon Service Quality Report," December 13, 2006. http://www3.dps.state.ny.us/pscweb/WebFileRoom.nsf/Web/BDE7EDAFD43A84AE8525724300640E80/$File/pr06074.pdf?OpenElement.

[171] / *Proceeding on Motion of the Commission to Consider the Adequacy of Verizon New York's Retail Service Quality Processes and* Programs, New York Public Service Commission Case 03-C-0971, *Order Directing Verizon New York Inc. to Demonstrate that Its Service Improvement Plans Are Sufficient*, December 19, 2006.

The Board's regulations should establish safeguards to create adequate incentives for Verizon to first improve and then to maintain its basic telephone service quality, and similarly for incumbent cable carriers to provide adequate service quality for basic cable products.

3.11. Consumers bear the cost of cross-subsidization.

Improper cross-subsidization harms consumers. When cross-subsidization occurs, companies charge high rates for regulated, noncompetitive services and divert resources toward new lines of business, jeopardizing the quality of basic services. Also, anticompetitive cross-subsidization thwarts emerging competition, which, in turn, denies consumers the benefit that a sufficiently competitive market would otherwise offer. Finally, improper cross-subsidization yields rates that are not aligned with costs: these inaccurate pricing signals lead to market distortions in the supply of and demand for telecommunications and cable services.

Absent regulatory intervention, incumbents will under-assign benefits and over-assign costs to their traditional lines of business, where they dominate markets. The foregoing discussion is not intended to be exhaustive, but rather to illustrate the compelling and invaluable assets that Verizon and incumbent cable operators enjoy by virtue of their historic dominance in New Jersey's markets. The next chapter discusses how existing policy fails to mitigate adequately harm to consumers.

4. EXISTING FEDERAL AND STATE POLICIES DO NOT PROTECT CONSUMERS ADEQUATELY

4.1. Introduction.

The previous chapters demonstrate that the telco and cable industries possess the incentive and the ability to subsidize unregulated services with noncompetitive ones, which, in turn, will distort the market and yield the economically inefficient supply and pricing of cable and telco services. Although federal and state legislation and policy prohibit cross-subsidization,[172] adequate accountability and incentives to encourage incumbents' compliance are sorely lacking. Relevant principles exist, but regulators lack the tools to deter anti-competitive abuses and to monitor firms' compliance. Indeed, as Chapters 2 and 3 demonstrate, Verizon possesses the ability and the incentive to leverage its market power (derived from its dominance of local, long-distance, and bundled services markets) to subsidize its foray into cable services. Similarly, cable companies possess the ability and incentive to leverage their monopoly position in the cable market to subsidize their pursuit of telephone services. This chapter summarizes some of the major existing policies and regulations that affect potential cross-subsidization, and also discusses some regulatory decisions that may provide useful models for designing appropriate safeguards in New Jersey today.

4.2. Federal Statutory Policy: The Telecommunications Act of 1996.

4.2.1. The goal of Section 254(k) is relevant, but, unless and until the Commission corrects carriers' assignment and allocation of common plant, cannot be achieved.

More than ten years ago, in its passage of the sweeping Telecommunications Act of 1996, Congress explicitly prohibited subsidization of competitive services by noncompetitive services. Section 254(k) of the 1996 Act states:

> A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.[173]

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[172] / 1996 Act, Section 254 (k); *N.J.S.A.*:48:2-21-18.c.

[173] / 1996 Act, Section 254 (k).

Despite this unambiguous statutory mandate, the FCC and state regulators have not yet established and enforced the necessary cost allocation rules and cost accounting safeguards to "ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."

The FCC's pending investigation of "separations" in Docket No. 80-286,[174] bears directly on its ability to prevent and to detect improper cross-subsidization, particularly as carriers use extensive common network and resources as an invaluable strategic and physical platform from which to enter unregulated lines of business, such as digital subscriber line service, bundled offerings, and FiOS-based Internet and video services.[175] Although the FCC's Part 64 rules address cross-subsidization in principle, they fail to protect consumers adequately in their implementation.[176]

The jurisdictional separations process determines the manner in which ILECs apportion regulated costs among jurisdictions (*i.e.,* interstate and intrastate jurisdictions). The FCC has stated: "one of the primary purposes of the separations process has been to prevent incumbent LECs from recovering the same costs in both the interstate and intrastate jurisdictions."[177] In conducting the jurisdictional separations process, carriers first assign the regulated cost of categories of plant and expenses (and sometimes among services with those categories). Carriers then allocate the costs in each category to the intrastate or interstate jurisdiction based upon: a relative use factor, a fixed allocator, or, by direct assignment (when allowed by Part 36 rules[178]).[179]

In discussing why competition and the advent of new technologies suggest a need for changes in the separations process, the FCC explained:

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174 / *FCC Separations FNPRM*. As noted above, the Rate Counsel is participating in this proceeding. *See*, Comments of the National Association of State Utility Consumer Advocates, the New Jersey Division of Rate Counsel and the Maine Office of the Public Advocate in CC Docket No. 80-286, August 22, 2006; Reply Comments of the National Association of State Utility Consumer Advocates, the New Jersey Division of Rate Counsel and the Maine Office of the Public Advocate in CC Docket No. 80-286, November 20, 2006; Affidavit of Susan M. Baldwin on behalf of the New Jersey Division of Rate Counsel and the National Association of State Utility Consumer Advocates in CC Docket No. 80-286, August 22, 2006.

175/ As discussed earlier, the FCC declared DSL to be an information service and also determined that Verizon and other Bells do not need to offer unbundled fiber to competitors. *Wireline Broadband Order.*

176 / Furthermore, as this chapter explains below, although the Board has the authority to establish and enforce cost accounting requirements, state accounting rules are inadequate.

177/ *FCC Separations FNPRM*, at para. 2.

178/ *FCC Separations FNPRM,* at para. 4.

179/ 47 C.F.R. Part 69.

> Jurisdictional cost shifts in separations results generally are caused by changes in any of three areas: overall cost levels, categorization of costs (*i.e.*, relative category assignments), or jurisdictional allocation factors. A carrier's increased overall cost level in a Part 32 account that has a high cost allocation to the interstate jurisdiction will cause shifts to the interstate jurisdiction for other investment and expense accounts whose jurisdictional allocations are dependent on that account. Increasing investment in specific categories (*e.g.*, interexchange cable and wire facilities (C&WF)) may also contribute to jurisdictional shifts in the final results. Likewise, changes in customer calling patterns (*e.g.*, increased interstate calling) will cause shifts in the jurisdictional allocation factors, many of which are based on usage. These factors allocate a significant portion of a carrier's investment between the interstate and intrastate jurisdictions.[180]

Cost accounting rules have not kept pace with the emergence of new technology and regulatory changes. Many major factors have created a substantial mismatch between intrastate regulated revenues, which exclude services such as DSL, , and intrastate regulated costs, which are based on the fixed intrastate/interstate allocation factor of 75%/25% for the local loop (the feeder and distribution networks and associated expenses), and frozen usage factors. Among the changes that render these frozen factors grossly incorrect are the deployment of new technologies such as DSL and fiber to the home and curb; jurisdictional changes such as the treatment of broadband,[181] VoIP,[182] and

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[180]/ *FCC Separations FNPRM*, at footnote 23.

[181] / The Commission determined that DSL service is interstate in 1998. *GTE DSL Order*, 13 FCC Rcd at 22474-83. The Commission subsequently determined that wireline broadband Internet service is an information service. *Wireline Broadband Order*.

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

calls to Internet service providers;[183] and Bells' Section 271 authority to offer long distance service.

The Federal-State Joint Board on Jurisdictional Separations remarked in a recent report that "Section 254(k) of the 1996 Act establishes a *duty* for the FCC and the states" to ensure that universal service "bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[184] The statutory prohibition set forth by Congress in the 1996 Act does not, in isolation, provide sufficient protection for consumers and competitors.

4.2.2. Although the Section 272 requirement for the separation of Bell operating companies' long distance operations has sunset throughout the country, it provides a useful model of safeguards.

4.2.2.1. Introduction

Among other things, the 1996 Act also set forth the requirement that Bell operating companies operate their in-region, long-distance business through separate affiliates, subject to specific requirements for a minimum of three years.[185] The purpose of the requirement for separate long-distance entities was to prevent anti-competitive cross-subsidization and to ensure that Bells did not discriminate in favor of their new long distance operations and against other long distance providers.

Section 272(a)(1) of the 1996 Act required a BOC to operate its in-region long distance business through one or more affiliates that are separate from any operating company entity that is subject to the requirements of section 251(c); and that meet the requirements of subsection (b) of Section 272. Section 272(b) establishes the relationship between the BOC and its in-region interLATA affiliate, and requires the separate affiliate to operate independently from the BOC. The affiliate must maintain its own separate

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

[184] / "Post-Freeze Options for Separations," State Members of the Separations Joint Board, October 25, 2005, included as Appendix B to the Separations ("Glide Path II Paper"), at 8, emphasis added.

[185] / These requirements sunset in all BOC territories during the period December 2002 (Verizon New York) through December 2006 (Qwest Arizona). *See*, http://www.fcc.gov/Bureaus/Common_Carrier/in-region_applications. In June, 2005, these requirements sunset for Verizon's operations in New Jersey. Federal Communications Commission, Public Notice, "Section 272 Sunsets for Verizon Communications, Inc. by the Operation of Law on June 24, 2005 Pursuant to Section 272(f)(1)," WC Docket No. 02-112, DA 05-1784. The Act's Section 272(f), provides, among other things, for the sunset of the separate affiliate requirement in section 272(a). With respect to interLATA telecommunications services in particular, 272(f) provides for sunset three years after grant of section 271(d)(3) approval, unless the Commission extends the three-year period by rule or order. For interLATA information services, the sunset period was four years after enactment of the 1996 Act (unless extended by rule or order).

books, records, and accounts; have separate officers, directors, and employees; and not obtain credit in a manner that would provide the creditor with recourse to the BOC. Section 272(b)(5) requires that the in-region interLATA affiliate conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection.

The Commission interpreted Section 272(f) to provide for a state-by-state sunset of the separate affiliate requirements,[186] and allowed the first sunset to occur with respect to Verizon New York as a matter of law. In a dissenting opinion attached to a Memorandum Opinion and Order determining state-by-state sunset, Commissioners Adelstein and Copps noted that although the Commission could have extended the separate affiliate requirements, instead the Commission allowed the 272 sunset without "necessary analysis." These two Commissioners stated further: "Congress clearly gave the Commission the charge to determine whether these structural, accounting, and auditing safeguards remain necessary to prevent anticompetitive discrimination in the market. Yet the Commission has neglected to consider whether there is a need for these or alternative safeguards."[187]

Several developments provide compelling evidence that alternative safeguards are long overdue:

- The growth in Verizon's bundles.
- Verizon's acquisition of MCI.
- Verizon's entry into the cable business.

The measures that originally governed Verizon's long-distance entry (before they sunset) included non-accounting and accounting safeguards.[188] In the orders establishing these safeguards, the FCC addressed such issues as accounting, affiliate transactions, non-discrimination, joint marketing, and enforcement, which are germane to the Board's design of cable rules that are compatible with fair and effective competition in New Jersey.

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[186] / *In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, FCC WC Docket No. 02-112, *Memorandum Opinion and Order*, rel. December 23, 2002, at para. 2.

[187] / Joint Statement of Commissioner Jonathan S. Adelstein and Commissioner Michael J. Copps, Dissenting in Part, Re: Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, FCC 02-336, December 23, 2002. Similarly, Commissioner Martin issued a concurring statement questioning the Commission's decision to allow the section 272 requirements to sunset and the fact that the decision was announced through a public notice rather "than a Commission order responding to questions raise on the record." Concurring Statement of Commissioner Kevin J. Martin, Re: Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, FCC 02-336, December 23, 2002.

[188] / The FCC addressed non-accounting safeguards in CC Docket No. 96-149 and accounting safeguards in CC Docket No. 96-150.

4.2.2.2. Accounting Safeguards.

In its initial order in the "Accounting Safeguards" proceeding,[189] the FCC stated, among other things:

> This Order prescribes the way incumbent local exchange carriers, including the Bell Operating Companies ("BOCs"), must account for transactions with affiliates involving, and allocate costs incurred in the provision of, both regulated telecommunications services and nonregulated services, including telemessaging, interLATA telecommunications, information, manufacturing, electronic publishing, alarm monitoring and payphone services, to ensure compliance with the Act. In particular, the Order adopts the tentative conclusion in the Notice of Proposed Rulemaking ("NPRM") in this proceeding that our current cost allocation rules generally satisfy the Act's accounting safeguards requirements when incumbent local exchange carriers, including the BOCs, provide services permitted under sections 260 and 271 through 276 on an integrated basis (i.e., within the telephone operating companies). The Order also adopts the tentative conclusion in the NPRM that our current affiliate transactions rules generally satisfy the Act's accounting safeguards requirements when incumbent local exchange carriers, including the BOCs, are required to, or choose to, use an affiliate to provide services permitted under sections 260 and 271 through 276. The Order adopts most of the NPRM's proposed modifications to the affiliate transactions rules to provide greater protection against subsidization of competitive activities by subscribers to regulated telecommunications services.[190]
>
> …
>
> In our NPRM, we set forth two goals for this proceeding: (1) preserving for the benefit of interstate telephone ratepayers legitimate economies of scope that could be realized by BOCs and other incumbent local exchange carriers when entering markets from which they were previously barred or in which they continue to participate; and (2) discouraging, and facilitating detection of, improper cost allocations in order to prevent incumbent local exchange carriers from imposing the costs of their competitive ventures on interstate telephone ratepayers. In the NPRM, we asked the threshold question: to what, if any, extent should we rely on our existing accounting safeguards in Parts 32 and 64 of our rules to achieve these two goals. We

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[189] / In the Matter of the Implementation of the Telecommunication Act of 1996, Accounting Safeguards under the Telecommunications Act of 1996, FCC CC Docket No. 96-150, Report and Order, rel. December 24, 1996 ("Accounting Safeguards Order").

[190] / *Id.*, at para. 1.

tentatively concluded that our existing accounting safeguards, with the modifications described in the NPRM, would best meet the requirements and underlying goals of sections 260 and 271 through 276. We invited comment on this tentative conclusion. We also sought comment on whether less detailed accounting safeguards would suffice to achieve the objectives of the Act.[191]

As the excerpt indicates, the FCC determined that its existing system of accounting safeguards found in Parts 32 and 64 of its rules satisfied the 1996 Act's accounting safeguard requirements *when a Bell used an affiliate to provide services*. The cost accounting safeguards consist of rules concerning affiliate transactions[192] and cost allocation.[193] Appendix 3 includes relevant excerpts from Parts 32 and 64 of the FCC's cost accounting rules.

These cost accounting rules, alone, will not protect consumers from bearing the cost and risk of Verizon's entry into new lines of business in New Jersey for, among others, the following reasons:

- The FCC's rules govern *interstate services.* Therefore, at a minimum, corresponding intrastaste cost accounting rules are necessary to protect intrastate ratepayers.[194]

- As a threshold matter, the Board's examination of Verizon's separation of costs between the intrastate and interstate jurisdiction is long overdue: Absent such an investigation, one cannot ascertain whether Verizon is assigning and allocating sufficient costs to the various services that have been deemed interstate or unregulated.[195]

- Without provisions for accountability and enforcement, rules are meaningless. Periodic audits conducted by a third party of Verizon's books and cost allocation methodology, subject to review by the Board and Rate Counsel, are essential.

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[191] / *Id.*, at para. 13.

[192] / 47 C. F. R. § 32.27.

[193] / 47 C. F. R. §§ 64.901-904.

[194] / Ten years ago, the FCC concluded that "[n]either the information contained in the record nor our experience provides us with any basis to conclude that existing state accounting systems that differ from our federal system will result in the type of subsidization of competitive activities prohibited by sections 260, 271, 272 and 274 through 276." *Accounting Safeguards Order*, at para. 44. However, as discussed later in this chapter, adequate accounting systems do not exist in New Jersey.

[195] / As Table 2 shows, DSL services in New Jersey represent a substantial and growing revenue source for New Jersey, yet the Board has not yet ascertained whether Verizon New Jersey's intrastate regulated operations are subsidizing improperly this line of business.

- Carriers need to put in writing the way in which they compensate the telco operations and retain these records so that these transactions can be reviewed.

4.2.2.3. Non-Accounting Safeguards.

In its initial *Non-Accounting Safeguards Order,*[196] which governed Bells' entry into long-distance markets, the FCC addressed issues such as non-discrimination,[197] joint marketing,[198] and enforcement.[199] In interpreting the 1996 Act's mandate that the Bells operate their long distance operations affiliate independently, the FCC prohibited the joint ownership of transmission and switching facilities and the property on which they are located, but did not prohibit all joint ownership of property.[200] The FCC also determined that although a Bell and its section 272 affiliate were required to have separate officers, directors and employees (that is personnel could not be on the payrolls of the Bell and its affiliate), sharing of in-house personnel was allowed, provided that the transaction complied with the provisions of section 272(b)(5) regarding affiliate transactions.[201] The FCC determined that the Bell and its affiliate could provide marketing services for each other, provided that they were provided pursuant to an arm's length transaction.[202] The FCC also determined that section 272(b)(4) of the 1996 Act prohibited a Bell from co-signing a contract or other financial instrument with a section 272 affiliate "that would allow the affiliate to obtain credit in a manner that grants the creditor recourse to the BOC's assets in the event of default by the section 272 affiliate."[203]

Among other things, the FCC reasoned as follows:

> These safeguards are intended both to protect subscribers to BOC monopoly services, such as local telephony, against the potential risk of having to pay costs incurred by the BOCs to enter competitive markets, such as interLATA services and equipment manufacturing, and to protect competition in those markets from the BOCs' ability to use their existing

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196 / *First Report and Order and Further Notice of Proposed Rulemaking*, CC Docket No. 96-149, released December 24, 1996 ("Non-Accounting Safeguards Order"). These provisions generally prescribe the manner in which the BOCs may enter certain new markets, including the in-region interLATA services market and the prohibitions on the integration of the affiliate's interLATA network with the BOC. In its Second Order on Reconsideration, the Commission addressed section 272(e)(4) in greater depth (rel. June 24, 1997).

197 / *Id.*, at paras. 198-236.

198 / *Id.,* at paras. 272-297.

199 / *Id.*, at paras. 318-352.

200 / *Id.*, at paras. 159-162.

201 / *Id.*, at paras. 178-181.

202 / *Id.*, at para. 183.

203 / *Id.*, at para. 189.

> market power in local exchange services to obtain an anticompetitive advantage in those new markets the BOCs seek to enter.[204]

Ten years later, Verizon continues to possess market power and continues to enter new markets beyond the scope of its intrastate regulated operations. Therefore, the FCC's reasoning applies to New Jersey's market today, and many of the safeguards that the FCC established to govern Bells' entry into long distance markets provide useful models to guide the Board's establishment of safeguards as cable and telecommunications companies enter each other's lines of business.

4.2.2.4. LEC Classification Order.

In the *LEC Classification Order*,[205] the FCC determined that dominant carrier regulation would be imposed on BOC interLATA affiliates only if they could unilaterally raise and sustain prices above competitive levels and thereby exercise market power. Dominant carriers, in contrast to non-dominant carriers, would be subject to price-cap regulation and follow tariff notice and filing requirements. The Commission states:

> In light of the requirements established by, and pursuant to, sections 271 and 272, together with other existing Commission rules, we conclude that the BOCs will not be able to use, or leverage, their market power in the local exchange or exchange access markets to such an extent that their section 272 interLATA affiliates could profitably raise and sustain prices of in-region, interstate, domestic, interLATA services significantly above competitive levels by restricting the affiliate's own output. We also conclude that regulating BOC in-region interLATA affiliates as dominant carriers generally would not help to prevent improper allocations of costs, discrimination by the BOCs against rivals of their interLATA affiliates, or price squeezes by the BOCs or the BOC interLATA affiliates. Although certain aspects of dominant carrier regulation may address these concerns, we conclude that the burdens they would impose on competition, competitors, and the Commission outweigh any potential benefits. As a result, we classify the BOC interLATA affiliates as non-dominant in the provision of in-region, interstate, domestic, interLATA services.[206]

However, telecommunications markets have become vastly more concentrated since the FCC issued this decision. SBC's acquisition of AT&T and Verizon's acquisition of MCI have altered the market structure substantially since the FCC issued

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[204] / *Id.*, at para. 6.

[205] / *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, CC Docket Nos. 96-149, 96-61, Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, 12 FCC Rcd15756 (1997) ("LEC Classification Order").

[206] / *Id.*, at para. 6.

its orders. As Appendix 2 shows, Verizon has rapidly re-monopolized bundled and long distance markets.

4.2.3. The 1996 Act also directed the Commission to establish nonstructural safeguards for Bells' payphone services.

The 1996 Act also requires nonstructural safeguards for Bells' payphone services. Specifically, Section 276(b)(1)(C) of the 1996 Act directs Commission to "prescribe a set of nonstructural safeguards for Bell operating company payphone service to implement the provision of paragraphs (1) and (2) of subsection (a), which safeguards shall, at a minimum, include the nonstructural safeguards equal to those adopted in the Computer Inquiry – III (CC Docket No. 90-623) proceeding."[207] Section 276(a) states that a BOC "(1) shall not subsidize its payphone service directly or indirectly from its telephone exchange service operations or its exchange access operations; and (2) shall not prefer or discriminate in favor of its payphone service."[208] The FCC issued its "Payphone Order" in September 1996, in which it set forth requirements for Bells' pay telephone operations.[209] In response to these requirements, in January 1997, Verizon (at the time, the Bell Atlantic Telephone Companies), filed a comparably efficient interconnection ("CEI") plan for basic payphone service with the FCC in which Verizon described how it would make its regulated basic services available on a nondiscriminatory basis to independent payphone service providers and to its own payphone operations.[210]

The 1996 Act required, among other things, that the safeguards, at a minimum, had to include the nonstructural safeguards that the Commission adopted in its *Computer III* proceeding.[211] As explained by the FCC, under the *Computer III* framework, Bells were required to describe in their Comparably Efficient Interconnection ("CEI") plans:

(1) the enhanced service or services to be offered;

(2) how the underlying basic services would be made available for use by competing ESPs [enhanced service providers]; and

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[207] / 47 U.S.C. § 276 (b)(1)(C).

[208] / 47 U.S.C. § 276 (a).

[209] / *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, *Report and Order*, FCC 96-338, released September 20, 1996 ("Payphone Order").

[210] / *In the Matter of Bell Atlantic Telephone Companies' Comparably Efficient Interconnection Plan for the Provision of Basic Payphone Services, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, *Order*, April 15, 1997.

[211] / 47 U.S.C. § 276(b)(1)(C).

(3) how the BOCs would comply with the other nonstructural safeguards imposed by *Computer III*.[212]

Among other things, Verizon demonstrated its compliance with the *Computer III* requirement that its enhanced services offering take the basic services at their unbundled tariff rates "as a means of preventing improper cost-shifting to regulated operations and anticompetitive pricing in unregulated markets."[213]

In the context of the cable regulations presently under review by the Board, similar protections are relevant to ensure that when Verizon and the cable industry offer triple and quadruple plays,[214] they compensate their basic operations properly. By way of illustration, when Verizon offers a "Freedom" package, which includes, for example, long distance, DSL, unlimited local calling, directory assistance, and custom calling features, Verizon should compensate its intrastate noncompetitive operations at tariffed rates for the unlimited local calling, directory assistance, and custom calling features that the bundle encompasses. When Verizon offers a bundle with FiOS-based cable, similarly, it should compensate its intrastate regulated operations based on the tariffed rates for any relevant portions of the bundle *and* should assign and allocate a fair share of any joint and common costs (such as marketing, overhead, shared network plant, etc.).

4.2.4. The FCC has a long history of establishing safeguards against cross-subsidization, which can inform the Board's design of effective cable franchising regulations.

In addition to its proceeding governing the Bells' entry into new lines of business, and its proceeding examining the adequacy of its cost allocation and separations rules in Docket 80-286, which are discussed above, the FCC has analyzed and addressed cross-subsidization in other proceedings. This paper does not attempt to replicate the nuances of each and every such FCC docket, but rather highlights some of the findings and policy that are particularly germane to today's market in New Jersey. Although measures that protect customers against bearing improperly the cost and risk of carriers' entry into new lines of business may seem archaic in today's rapidly evolving information age, today's marketplace – although in flux – is not sufficiently competitive. Therefore, despite the hoopla about competition, customers of basic telecommunications and basic cable services (whom neither the cable nor telco markets seek to attract and retain), competitors, and potential new entrants are vulnerable to the harmful effects of improper cross-subsidization.

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212 / *Payphone Order*, at fn 36, citing *Amendment of Section 64.702 of the Commission's Rules and Regulations,* CC Docket No. 85-229, Phase I ("Phase I Order"), 104 FCC 2d at 1034-59, paras. 142-200.

213 / *Payphone Order*, at para. 20, citing *Phase I Order*, at para. 159.

214 / Triple play refers to a bundle including voice, data, and video. Quadruple play includes voice, data, video, and wireless.

4.2.5. Competitive Orders.

The FCC's *Competitive Carrier Fifth Report and Order,*[215] issued in 1984, included limited structural safeguards requirements. Between 1979 and 1985, the Commission conducted the *Competitive Carrier* proceeding, in which it examined how its regulations should be reformed to address competition in telecommunications markets. In a series of orders, the Commission distinguished between carriers with market power (dominant carriers) and those without market power (non-dominant carriers). Over time, the Commission relaxed its regulation of non-dominant carriers because it concluded that non-dominant carriers could not engage in conduct that may be anticompetitive or inconsistent with the public interest.

In its *Competitive Carrier First Report and Order*, the Commission classified local exchange carriers and legacy AT&T as dominant carriers and concluded that these dominant carriers should be subject to all of the then-existing Title II regulations. The Commission reclassified legacy AT&T as a non-dominant carrier in the interexchange market after determining that legacy AT&T no longer possessed the ability to unilaterally control prices in the interstate, domestic, interexchange telecommunications market.

In its *Fourth Report and Order*, the Commission considered how it should regulate the provision of interstate, interexchange services by independent LECs. The Commission determined that interexchange carriers affiliated with independent LECs would be regulated as non-dominant carriers. In the *Competitive Carrier Fifth Report and Order*, the Commission clarified that an "affiliate" of an independent LEC for purposes of qualifying for regulation as a non-dominant carrier is "a carrier that is owned (in whole or part) or controlled by, or under common ownership (in whole or part) or control with, an exchange telephone company."[216] The Commission determined that in order to qualify as a non-dominant carrier, the interexchange carrier affiliated with an independent LEC was required to:

> (1) maintain separate books of account;
>
> (2) not jointly own transmission or switching facilities with the exchange telephone company; and
>
> (3) obtain any exchange telephone company services at tariffed rates and conditions.[217]

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[215] / *Policy and Rules Concerning rates for Competitive Carrier Services and Facilities Authorizations Therefore,* FCC CC Docket No. 79-252*, Fifth Report and Order*, 98 FCC 2d 1191(1984)("Competitive Carrier Fifth Report and Order").

[216] / *In the Matter of Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services*, FCC CC Docket No. 96-21, *Notice of Proposed Rulemaking*, rel. February 14, 1996, at para. 4, citing *Competitive Carrier Fifth Report and Order.*

[217] / *Competitive Carrier Fifth Report and Order*, at para. 9.

The Commission further concluded that, if an independent LEC provided interstate, interexchange services directly, rather than through an affiliate, those services would be subject to dominant carrier regulation.

4.2.6. Relevance of FCC orders to the Board's rulemaking proceeding.

The previous discussion of various regulatory decisions in which the FCC implemented specific safeguards and enforcement provisions to ensure that the telecommunications industry could evolve in a competitively neutral way is intended to highlight possible elements of a system of safeguards for New Jersey. The particular system of safeguards the Board establishes can draw upon the rationale and measures of these prior regulatory decisions and then be tailored to the specific goals of New Jersey to encourage the development of an advanced information infrastructure without improper cross-subsidization.

4.3. New Jersey statute prohibits improper cross-subsidization.

In a statutory mandate that parallels the directive that the federal 1996 Act establishes, a New Jersey statute, enacted in 1992, prohibits the subsidization of competitive services with revenues derived from noncompetitive services. The Legislature stated that "[n]o local exchange telecommunications company may use revenues earned or expenses incurred in conjunction with noncompetitive services to subsidize competitive services."[218] However, as is the case with the federal statute, absent regulatory tools to monitor and audit carriers' accounting, the statutory prohibition, by itself, provides insufficient consumer protection. The following section discusses some of the Board's findings on this issue, and demonstrates that further Board guidance is essential to facilitate the competitively neutral evolution of an advanced information infrastructure in New Jersey that does not rely on consumers of basic telco and cable services to subsidize the industries' entry into new lines of business.

4.4. Board of Public Utilities policy.

4.4.1. *PAR-1 Order/PAR-2 Order.*

In its Order approving a plan of alternative regulation ("*PAR-I Order*"), which revised the form of regulation governing Verizon's intrastate telecommunications operations, the Board chose not to impose structural separations upon Verizon, but rather to to rely on embedded analysis system ("EAS") reporting.[219] The Board determined that

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218 / *N.J.S.A.*:48:2-21-18.c.

219 / *In the Matter of the Application of New Jersey Bell Telephone Company for Approval of Its Plan for an Alternative Form of Regulation*, Docket No. T092030358, May 6, 1993 ("PAR-1 Order"). The Board addresses cross-subsidization and structural safeguards beginning at page 98 of the *PAR-1 Order*, see especially pages 99 – 115.

the EAS reports provided "an appropriate non-structural safeguard to ensure that the costs of NJ Bell are properly allocated and to ensure that cross-subsidization does not occur."[220] The Board further reasoned that EAS "is a cost allocation system now used by the Board to monitor NJ Bell's earnings for surveillance purposes under the Rate Stability Plan," and that the EAS "identifies and allocates all of the Company's costs, including all overhead costs, among all of the Company's services including not only directly assigned costs, but appropriate indirect costs as well."[221] The Board determined that it was not necessary to order structural safeguards.[222] During the Board's *PAR-1* investigation, it was observed that:

> The embedded analysis system is excessively and unnecessarily obtuse. NJB should not be permitted to embark on a new form of regulation unless and until it has responded to Staff's request for the design of a reasonable substitute for the quarterly report it now submits. Each and every allocator should be able to be understood by the Board and deemed appropriate.[223]

The need for clear accounting of carriers' assignment and allocation of costs is as relevant today as it was fifteen years ago.

The Board, in its *PAR-1 Order* also acknowledged that local telephone companies' provision of video programming could cause the FCC to impose structural safeguards at a later time.[224] Also, the Board stated, among other things, that it "reserves the right to consider, and impose to the extent permitted by law, other safeguards, such as fully separated subsidiaries, if this subsequently appears necessary."[225] Now that telecommunications and cable companies are entering each others' respective markets, fully separated subsidiaries should once again be considered by the Board.

In its *PAR-2 Order*, which further modified the regulatory framework governing Verizon's operations in New Jersey, the Board discontinued the EAS reporting requirement, stating:

> In addition, we FIND that PAR-2 provides for the simplification of monitoring and reporting on potential cross-subsidization of competitive services from non-competitive services. The Board DIRECTS VNJ to (1)

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[220] / *Id.*, at 106. *See also, id.*, at 108.

[221] / *Id.*

[222] / *Id.*, at 109.

[223] / *In the Matter of the Application of the New Jersey Bell Telephone Company for Approval of its Plan for an Alternative Form of Regulation*, New Jersey BPU Docket No. T092030358, Direct Testimony of Susan M. Baldwin, on behalf of the New Jersey Cable Television Association, filed September 21, 1992, at 32-33.

[224] / *PAR-1 Order,* at 111-112.

[225] / *Id.,* at 112.

> provide annual financial reports to the Board so that it may monitor the revenue and costs of its competitive services, and determine whether, in the aggregate, the total revenues for VNJ's competitive services exceed the total direct costs of those services, and (2) eliminate reports from the EAS system, and to provide annual financial reporting of its rate regulated services and to work together with Staff and the Advocate to determine the format for such annual financial reporting on its rate regulated services, and to ensure, as much as reasonably possible, that the format is consistent with similar reporting in other Verizon jurisdictions.[226]

In its earlier *PAR-1 Order,* the Board relied on EAS reports rather than structural separations to prevent improper cross-subsidization. However, as the above excerpt indicates, the *PAR-2 Order* eliminated the reasoning for the Board's original rejection in its *PAR-1* decision on structural separations (namely quarterly EAS reports). Therefore, the logic upon which the Board relied in its *PAR-1* decision to reject structural separations (namely the existence of EAS reports) evaporated with the *PAR-2 Order*. As a result, the Board should now revisit the merits of structural separations. Now, as new lines of business consume an increasing share of Verizon's corporate attention and priority,[227] conditions have changed sufficiently to merit the Board's close attention to these issues again. Furthermore, when the Board issued the *PAR-2 Order* four years ago, the focus of the concern was telecommunications services. Under the Cable Act,[228] Verizon's video programming service is a cable service, and therefore is not addressed by the *PAR-2* analysis.

Moreover, although the Board directed Verizon to work with Staff and the RatepayerAdvocate to determine the format for the annual reports, no such effort has been undertaken, nor has the intended monitoring occurred. Without these reports or similar ones, the Board and Rate Counsel lack the rudimentary information necessary to detect any improper cross-subsidization. Verizon NJ should submit detailed financial and cost accounting reports that enable the Board to understand and to assess the way in which Verizon NJ assigns and allocates costs among its various lines of business. Furthermore, the methods and magnitude of cost assignment and allocation should be clear.

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[226] / *In the Matter of the Application of Verizon New Jersey Inc. For Approval (I) of a New Plan for an Alternative Form of Regulation and (ii) to Reclassify Multi-Line Rate Regulated Business Services as Competitive Services, and Compliance Filing*, New Jersey Board of Public Utilities Docket No. TO01020095, *Decision and Order*, August 19, 2003 ("PAR-2 Order"), at 54.

[227] / Sections 3.9.1 through 3.9.3 demonstrate that Verizon is neglecting basic telecommunications services as it deploys FiOS deployment and in its race to offer cable. The re-assignment of field technicians to support FiOS deployment is an example of a form of improper cross-subsidization.

[228] / P.L.1972, c.186 (C.48:5A-1 *et seq.*), as amended and supplemented ("Cable Television Act" or "Cable Act").

Based on technological and regulatory developments that the Board could not have anticipated fully when it issued its *PAR-2 Order*, the time is ripe for the Board to re-assess its regulatory tools for preventing and detecting improper cross-subsidization.

4.4.2. The Board's reasoning and analysis in its investigation of energy utilities applies equally to the telco-cable industries.

The Board's reasoning underlying the rules adopted in October 2006 for energy competition and public utility holding companies is germane to the Board's development of cable regulations. The Board has a comprehensive regulatory scheme in place to regulate New Jersey utilities and the relationships of the utilities with their affiliates to the extent those relationships might interfere with the utilities' provision of safe, adequate and proper service to their customers at reasonable rates. This authority is broad and includes authority over rates, service quality, affiliate transactions, the transfer of control over a public utility as well as a variety of other areas.

Additionally, the Board has many other avenues for protecting utilities from any risk of affiliate diversification, through the control of regulatory capital structure, rates of return, the sale or encumbrance of utility assets, contracts with affiliates, and its general authority over customer rates. If necessary, the Board can require any New Jersey utility that is not already so structured to operate as a separate legal entity from its parent or affiliates, as most (if not all) New Jersey utilities already do and can impose other "ring fencing" protections.

The Board confirmed its authority when it concluded: "It is well established that the Board 'may exercise jurisdiction not only over the bottom corporate tier of the chain, the actual New Jersey [public utility], but to any entity which owns, controls, manages or operates that entity.'"[229] The Board further stated that:

> This sweeping grant of power is "intended to delegate the widest range of regulatory power over utilities to the [BPU]" . . . The BPU's authority over utilities, like that of regulatory agencies generally, extends beyond powers expressly granted by statute to include incidental powers that the agency needs to fulfill its statutory mandate.[230]

The Board also correctly identified the risks that are involved when public utilities diversify and invest in non-utility businesses. The Board explains:

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[229] / 38 N.J.R. 4237(a), Volume 38, Issue 19, New Rules: *N.J.A.C.* 14:4-4A, issued October 2, 2006, Energy Competition Standards, Public Utility Holding Company Standards ("Energy Competition and Public Utility Holding Standards"), at 7, quoting N.J.S.A 48:2-13 and also citing *In Re Proposed Corporate Restructuring of Tele-Communications, Inc*., BPU Docket No.CM90121496, Order dated February 2, 1991.

[230] / *Id.,* at 7, cites omitted.

EXISTING FEDERAL AND STATE POLICIES DO NOT PROTECT CONSUMERS ADEQUATELY

> Ratepayers of utilities face at least three categories of risk when their utility, or its holding company, invests in nonutility businesses. First, the utility holding company investments in non-utility businesses may lead to utility ratepayer subsidies of non-utility services, second, the acquisition of a utility by a holding company can affect the incentives of utility management as new management may have priorities other than local utility service and may lack the State-specific experience necessary to ensure reliable service at reasonable rates. Third, because the utility industry is capital intensive, utilities are highly dependent on access to the capital markets. When the utility's credit ratings decline as a result of activities at the parent holding company or affiliate, the compensation demand by providers of capital can increase, putting ratepayers at risk.[231]

The Board's reasoning in its recent energy order applies equally to the telecommunications and cable industries.

4.4.3. The Cable Act also established Board authority to protect cable ratepayers as cable companies diversify into new lines of business.

Similarly, the Cable Act has the same type of broad provisions that are found in sections of Public Utility Law and these parallel provisions give the Board the same authority to protect cable ratepayers when cable companies diversify into other non-cable businesses, like telephone and Internet services.[232] This broad authority compels that the Board impose appropriate safeguards on both telephone companies and cable companies as part of this rulemaking.

The New Jersey Legislature recognized the importance of consumer protection, stating:

> That, in order to afford an equal opportunity for non traditional MVPD providers such as local telephone common carriers to compete with existing providers, and to ensure that customers receive the benefits of a more competitive MVPD market, it is in the public interest to encourage common carriers to enter the MVPD market by adapting the existing regulatory framework to the changed circumstances brought about by recent technological developments while allowing the State to retain its necessary and appropriate regulatory oversight with regard to consumer protection and customer service elements; and
>
> That nothing in this act shall be seen to limit or otherwise reduce the protection afforded to cable television customers, and it is in the public interest to include additional provisions in this act to ensure that customers

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[231] / *Energy Competition and Public Utility Holding Standards*, at 4.

[232] / P.L.1972, c.186 (C.48:5A-1 *et seq.*), as amended and supplemented.

continue to be provided a high level of consumer protection and customer service in a more competitive MVPD market.[233]

4.5. Drawing upon relevant federal and state precedent, analysis, and models, the Board can establish workable and fair safeguards to protect consumers and competitors from improper cross-subsidization.

This chapter describes existing federal and state mandates to prevent improper cross-subsidization as well as salient aspects of federal and state models for safeguards. As this chapter demonstrates, although the federal and state statutory mandates to prevent cross-subsidization are unambiguous, the Board lacks the requisite regulatory tools to ensure accountability by the industry in complying with this mandate. Chapter 5 describes the key elements of such tools.

[233] / P.L.1972, c.186 (C. 48:5A-2, §§ g and h).

5. RATE COUNSEL PROPOSAL TO PROTECT CONSUMERS

5.1. Improved safeguards are required to guide the state's development of an advanced infrastructure.

As the previous chapters demonstrate, the existing federal and state regulatory frameworks are inadequate to protect Verizon's telecommunications customers from subsidizing Verizon's FiOS-based entry into video services and to protect the cable industry's customers from subsidizing cable industry's entry into telephone service. The structural separations between telecommunications and cable operations by Verizon and incumbent cable operators would enable the Board to ensure that rates are just and reasonable, and that companies in New Jersey do not engage in improper cross-subsidization. The FCC's decision in 2005 to decline to require Verizon and other Bells to provide unbundled fiber to competitors[234] is another reason that Verizon should conduct its new lines of business separately from its intrastate regulated operations. Also, Verizon's *pro forma* financial statements for its cable operations do not include the cost of using the telecommunications network.[235] With this type of major diversification, circumstances have changed substantially since the Board issued the *PAR-2 Order*.

The benefits of such safeguards to consumers, competitors, and the New Jersey economy are significant. The safeguards will protect consumers from bearing the costs and risks of incumbents' entry into new lines of business. The safeguards also will facilitate the development of a robust, economically sound information infrastructure for New Jersey's households and businesses. This chapter provides the fundamental framework for such safeguards.

5.2. Safeguards, by preventing anticompetitive exercise of market power, will encourage the efficient supply of broadband, cable, and telecommunications services.

Presently, the United States ranks 12th in the world in broadband deployment, with 19.2 broadband subscribers per 100 inhabitants.[236] Relying on industry promises is not a reliable way to accelerate New Jersey's development of a globally competitive infrastructure. As one pundit recently observed with reference to net neutrality, "AT&T has promised not to discriminate—not to 'prioritize, degrade, or privilege' based on

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[234] / *Wireline Broadband* Order, at para. 87.

[235] / This statement is based upon authors' conversation with Rate Counsel, who reviewed the confidential *pro forma* financial statements submitted with Verizon's application.

[236] / Organisation for Economic Co-operation and Development, http://www.oecd.org/document/9/0,2340,en_2649_34223_37529673_1_1_1_1,00.html. Denmark leads the world with 29.3 broadband subscribers per 100 inhabitants.

'source, ownership, or destination.' And if AT&T indeed plays by those rules, its expanded size and efficiency may do much to restore America's slipping status in the Internet world."[237] The key question is whether AT&T and other Bells will "play fair."[238] Similarly, in New Jersey, the degree to which the Board allows Verizon and the cable industry to wield their dominance will affect the state's broadband infrastructure. Turning over consumers' pocketbooks to the industry is not an economically efficient way to ensure deployment.[239]

5.3. Broad-based support for net neutrality provides compelling evidence of support for consumer protection.

The unprecedented net neutrality provisions of the AT&T/BellSouth merger,[240] the recently introduced federal legislation to protect net neutrality,[241] and broad citizen support for net neutrality[242] all provide compelling evidence of broad-based concern about leaving the future of the nation's information infrastructure in the hands of a cable-telco duopoly. Similarly, it would be imprudent for the Board to allow the cable and telco industries in New Jersey to dictate the terms of their entry into each others' turf without adequate oversight of the way in which they assign, allocate, and recover costs.

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237 / "Ma Bell is back, should you be afraid," Tim Wu, www.slate.com, posted January 4, 2007.

238 / The net neutrality provision that the AT&T/BellSouth merger encompasses is tenuous not only because it has a two-year lifespan, but also because two of the FCC commissioners do not seem to support the goal of net neutrality. They stated: "[fo]r example, today's order does not mean that the Commission has adopted an additional net neutrality principle. We continue to believe such a requirement is not necessary and may impede infrastructure deployment." *In the Matter of AT&T and BellSouth Corporation Application for Transfer of Control*, WC Docket No. 06-74, Joint Statement of Chairman Kevin J. Martin and Commissioner Deborah Taylor Tate. To the extent that the FCC fails to provide consumer protections to Bells' customers, Board oversight to ensure that Verizon and the cable industry compete fairly becomes that much more important.

239 / Furthermore, unlike in AT&T's region, consumers in the Verizon-served New Jersey region lack the benefit of the commitment to affordable broadband that the recent AT&T/BellSouth merger conditions provide. Verizon's promises to deploy the pricier FiOS platform throughout the state will not provide benefits to consumers seeking more affordable ways to access the Internet. As Table 3, *supra*, shows, consumers pay $39.95 for stand-alone FiOS-based access to the Internet. Verizon's DSL-based Internet, by comparison, is $19.95, and AT&T's comparable service is $10.00. Although FiOS offers superior speed and capability, some customers seek a lower capacity and more affordable way to access the Internet. Verizon's push to deploy FiOS will likely distract it not only from installing and repairing basic telephone service in a timely manner, but also from deploying DSL at an affordable rate.

240 / *In the Matter of AT&T and BellSouth Corporation Application for Transfer of Control*, WC Docket No. 06-74, FCC News Release, "FCC Approves Merger of AT&T Inc. and BellSouth Corporation," December 29, 2006; AT&T/BellSouth Merger Conditions.

241 / A bill, with bipartisan support, the "Internet Freedom Preservation Act" (S. 215), was introduced on January 9, 2007, by Senators Byron Dorgan and Olympia Snowe.

242 / *See, e.g.,* www.savetheinternet.com; www.freespress.net; www.itsournet.org.

If there were sufficient competition in the provision of information pipes, support for protecting net neutrality likely would not be so widespread. The same lack of competition that has propelled nationwide cries for net neutrality also implicates the converging telco-cable industry in New Jersey and is compelling evidence of concern about the market power that the cable-telco duopoly exerts.

As Chapter 2 demonstrates, the Hatfield-McCoy cable-telco rivalry does not represent sufficient competition. Morever, their efforts to squelch municipal pursuit of broadband belie their attempt to persuade regulators that the market is competitive.[243]

5.4. Regulated services should be compensated for the use of common network and resources that support new lines of business.

Verizon reports in the October 30, 2006 *Investor Quarterly* that 7.5 million customers subscribe to its Freedom packages.[244] Consumers of bundled services, such as the Freedom package, are prime candidates for bundled services via FiOS. In fact, Verizon executives tout the effect that FiOS has on bundles. In a conference for industry analysts, a Verizon executive states that 99% of all FiOS customers take at least two products and that 79% take three products.[245]

Verizon's current base of DSL customers are prime targets for its FiOS marketing campaigns, and this contingent is growing quickly. At the end of 2005, New Jersey alone had 540,382 DSL connections and 1,205,182 cable-based high-speed modem lines.[246] Verizon likely serves the vast majority of these New Jersey DSL connections and will likely to seek to convert these households into FiOS subscribers. Figure 10 shows the substantial increase in demand for DSL in New Jersey between year-end 2000 and year-end 2005.

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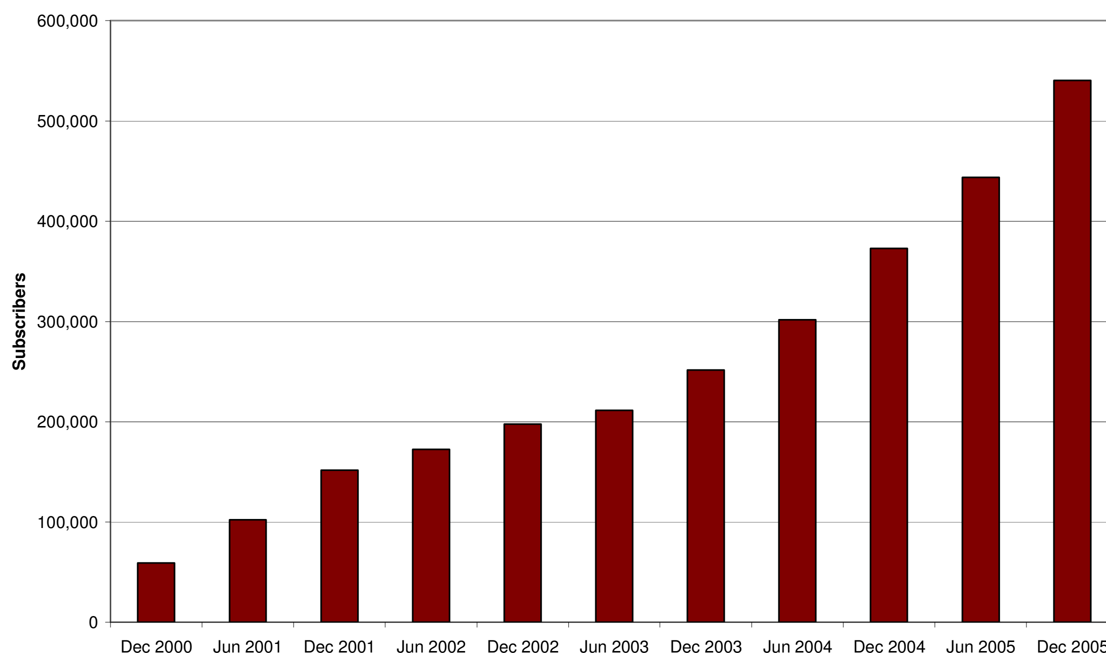
[243] / *See,e.g.,* http://www.onthemedia.org/transcripts/2007/01/05/05.

[244] / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at page 6.

[245] / Verizon FiOS Briefing Session, at page 5.

[246] / *FCC High-Speed Services July 2006 Report*, at Tables 11 and 12.

Figure 10
New Jersey's DSL Subscriber Base Has Grown 811% in Five Years



Source: FCC, *High-Speed Services for Internet Access: Status as of December 31, 2005*, July 2006, Table 11.

5.5. Verizon's cable operations should compensate Verizon's telco operations for the value of the Verizon brand.

Verizon's success in marketing and selling cable services to New Jersey consumers will be based in large part on the Verizon "brand" and the widespread name recognition it has acquired by virtue of supplying New Jersey households and businesses for more than a century.[247] The FCC, in its order addressing Bells' long-distance entry, observed that "the BOCs and other firms, notably existing interexchange carriers, will be able to offer a widely recognized brand name that is associated with telecommunications services."[248] With the substantial concentration that has occurred in the market, the value of Verizon's brand name has increased. Therefore, Verizon should compensate its regulated operations accordingly.

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[247] / By way of illustration, Verizon recently spun off its directory publishing operations for approximately $2 billion in cash and a reduction of Verizon's debt by $7 billion. Verizon Communications, Inc., "Verizon CFO Provides Updates on Initiatives to Enhance Shareholder Value," December 6, 2006. The value of Verizon's directory publishing operations is attributable in large part to its historic role as the incumbent local telephone company.

[248] / *Non-Accounting Safeguards Order*, at para. 7.

5.6. Structural safeguards, whereby the telco and cable lines of business are conducted in separate operations, would protect consumers most effectively.

The previous chapters and the accompanying appendixes demonstrate that the telco and cable industries possess the incentive and the ability to subsidize competitive pursuits with revenues from noncompetitive products and with common and joint resources. Verizon has not demonstrated to the Board that Verizon has compensated adequately its regulated intrastate operations for its unique access to a ubiquitous base of customers and to a ubiquitous public switched network, which it uses to the benefit of its DSL and FiOS-based services.

Furthermore, as Chapter 2 shows, there is insufficient competition in today's cable and telco markets to discipline rates for basic telecommunications services and for basic cable services.[249] Finally, if Verizon's multi-billion entry into the cable market proves unprofitable, structural separations will protect future generations of ratepayers.[250] For these various reasons, the Board should establish rigorous safeguards to address the market failure and existing regulatory vacuum. The goal of the safeguards is to prevent anticompetitive abuse, to protect consumers from firms' power to raise and sustain rates above competitive levels, and to encourage the economically efficient supply and deployment of an advanced information infrastructure throughout New Jersey.

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[249] / The options that are emerging for triple and quadruple play customers do not discipline the rates, terms, and conditions for basic local exchange and basic cable services. The idea that competition for customers seeking bundles somehow protects the customer who seeks only basic "no-frills" local exchange service is nonsensical. Instead, Bells are pursuing "high-end" customers and neglecting the low-revenue customers. The market's abandonment of the basic customer became evident in 2004 when AT&T announced its intention to "harvest" mass market customers. Citing among other sources, AT&T Declarant John Polumbo and the Q4 2004 AT&T Earnings Conference Call, the FCC states, "[w]e base this conclusion on AT&T's cessation of marketing, its reductions in consumer operations, its retirement of infrastructure used to support mass market marketing and consumer care for mass market services, and its decision to 'harvest' its mass market business by raising prices, resulting in a declining mass market customer base." *In the Matter of SBC Communications Corp. and AT&T Corp, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-65, Memorandum Opinion and Order, Rel. November 17, 2005 ("SBC/AT&T Merger Order"), at para. 313. The FCC explains further that "'[h]arvesting' refers to AT&T's increasing prices to encourage customers to discontinue service" and that "'[h]arvesting' refers to AT&T's steps to manage the decline in its mass market business." *Id*., at fn 313.

[250] / Experience in the electric industry may be instructive. Federal and state regulators, anticipating that competition would yield lower prices, eliminated many forms of rate protection for consumers of electricity. A decade later, consumers are seeing rate increases, and the anticipated competition has failed to materialize. "Competitive Era Fails to Shrink Electric Bills: More Increases Are Seen – Some States Are Seeking to Return to a System of Regulated Prices," *The New York Times*, October 15, 2006, at 1. Also, while consumers confront rate increases, investors, which purchased power plants, are reaping vast profits. "In Deregulation, Power Plants Turn Into Blue Chips," *The New York Times*, October 23, 2006, at 1. Absent adequate regulatory protection and proper cost accounting, consumers of intrastate telecommunications regulated services will be at risk of future rate increases.

Measures to prevent improper cross-subsidization need to be balanced with the goal of allowing firms to benefit from economies of scope, that is, the more a firm integrates its operations the lower its costs may be.[251] A trade-off exists between the efficiency of integrated operations and the potential for improper cost allocation, similar to that recognized by the FCC in its establishment of safeguards that originally governed Bells' entry into the long-distance market.[252] In today's regulatory environment, the scales are tipped toward improper cost-allocation. As Bells enter cable territory and as cable companies enter telco territory, safeguards to minimize improper cross-subsidization are essential. By way of illustration, as Chapter 4 discusses, the FCC established safeguards to guide Bells' entry into long distance services. Among other things, the FCC reasoned as follows:

> We agree with the claims of some commenters that, because the costs of wired telephony networks and network premises are largely fixed and largely shared among local, access, and other services, sharing of switching and transmission facilities may provide a significant opportunity for improper allocation of costs between the BOC and its section 272 affiliate.[253]

The Board now confronts a similar situation, which necessitates similar measures. Where costs are largely fixed and shared, there is a significant opportunity for improper cost allocation and discrimination. The safeguards should:

- Ensure that new lines of business compensate regulated lines of business for any use of shared expertise, resources, personnel, tariffed services, and/or other assets.

- Eliminate the incentive for Verizon's telco operations to favor Verizon's cable business, and eliminate the incentive for cable companies' operations to favor their own telco business.

The Board should permit a common corporate parent, but require structurally separate affiliates, whereby the affiliates operate independently, based on the Section 272 long-distance model. The separate affiliate requirement would sunset and integrated operations could occur only upon an affirmative finding by the Board that sufficient alternative safeguards existed.

At a minimum, the Board should establish regulations that:

- Require Verizon and incumbent cable operators to maintain separate books of account for their telco and cable businesses.

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[251] / Economies of scope occur when it is less costly for a single firm to provide a bundle of goods than for two or more firms to provide them separately.

[252] / *Non-Accounting Safeguards Order*, at para. 13.

[253] / *Id.*, at para. 159, cite omitted.

RATE COUNSEL PROPOSAL TO PROTECT CONSUMERS

- Prevent joint ownership of facilities with affiliates.
- Require the affiliate to obtain any services at tariffed rates and conditions.
- Prohibit the incumbents from discriminating between affiliates and other entities.
- Require incumbents and their affiliates to conduct any joint research and development on a compensatory basis.
- Require the incumbent to put in writing any transactions between the separate subsidiary and its affiliates.
- Require the affiliates to negotiate on an arm's length basis.
- Require the incumbents to submit clear descriptions of cost accounting and cost allocation methodology to the Board and to the Rate Counsel.
- Require the incumbents to maintain a complete audit trail of all cost allocation and affiliate transactions.
- Require the submission of annual reports to the Board and to the Rate Counsel specifying incumbents' relative levels of investment and employment in their intrastate regulated operations separately from corresponding levels in their new lines of business.
- Require incumbents to maintain books, records, and accounts separate from their new lines of business.
- Establish an expedient complaint process for allegations of cross-subsidization
- Either prohibit sharing of marketing personnel or allocate shared personnel costs based on fair market value.
- Establish service quality standards, and, as is necessary, financial incentives to ensure the adequacy of basic telecommunications and cable services.
- Require the incumbents to submit to the Board and to Rate Counsel, on a quarterly basis, financial reports, an income statement, a balance sheet, and a statement of cash flows separately for incumbent line of business and new lines of business.
- Require annual audits of sales practices.

- Impose penalties for non-compliance with cost accounting and service quality regulations.

The Board should ensure that Verizon and the cable industry offer their new lines of business on an arm's length basis to minimize the opportunities for anti-competitive behavior.

The goals of these safeguards are to:

- Encourage competition to develop on an equal footing.
- Ensure that Verizon NJ and the cable industry do not neglect the quality of their basic services in their rush to compete in the converged triple play market.
- Protect consumers from the cost and risk of the industry's entry into new markets.

The most effective way to prevent improper cross-subsidization is to require the creation of distinct affiliates with accounting and non-accounting safeguards. As a second best approach, the Board should establish a comprehensive and feasible set of non-structural safeguards to detect and to deter improper cross-subsidization. The safeguards should ensure, among other things, that:

- New lines of business compensate the incumbent operations for any employee transfers and reliance on shared personnel.
- New lines of business compensate the incumbent operations for the value of the incumbent's "brand."
- The incumbents' books and transactions are clearly maintained and that their books are subject to annual audits.
- Verizon provides detailed and lucid explanations of the way in which it assigns and allocates costs associated with its FiOS and cable operations. As an integral component of its filing, Verizon should identify any and all joint and common resources (including, but not limited to common physical network plant, office space, management, sales and advertising, general support and administrative expenses, etc.).
- Verizon demonstrates that its FiOS-related and cable revenues cover their associated costs, and, in the absence of such a showing, demonstrates that revenues from its regulated operations are not being used to subsidize its entry into new lines of business.

- Incumbents describe clearly and thoroughly to the Board the way in which they charge their unregulated lines of business for use of common resources.
- The accounts, cost methodology, and finances of the company's regulated and nonregulated operations are subject to annual audit by third party.
- Sales practices are subject to annual audits.
- Penalties for non-compliance with regulatory safeguards and service quality standards exist.

5.7. Enforcement measures are essential to counteract the economic incentive to engage in improper cross-subsidization.

Regardless of whether the Board establishes structural or non-structural safeguards, the design and implementation of feasible and effective enforcement measures are essential to protect consumers from paying high rates for basic telephone and cable services and to ensure that competitors have a fighting chance of competing with the Goliath-like cable-telco duopoly that now dominates the information pipes in New Jersey. A key element of the enforcement should include provisions for audits.

When confronted with Verizon's request to discontinue the auditing condition of the Bell Atlantic/GTE merger, the FCC stated:

> We reject Verizon's claim that these compliance requirements obviate the need for the independent auditor condition. As previously stated, the Commission found that the compliance program protected the public interest, but only in conjunction with the independent auditor condition. A quarterly report or compliance reports is not a substitute for an independent auditor condition. Verizon's obligations to file unaudited quarterly and compliance reports do not provide an independent review of Verizon's performance. During the audit process, the Commission staff, state commissions, and independent auditor have access to the working papers, supporting materials, and interpretations underlying Verizon's compliance assertions that may not be disclosed in the performance reports or available to third parties. Finally, when contemplating the merger, the Commission considered the independent auditor condition a useful tool to supplement its usual investigative authority. In view of the foregoing, we find no reason to alter our prior conclusion that the compliance mechanisms discussed in Verizon's request are not substitutes for the independent auditor condition.
>
> Lastly, Verizon contends that we should discontinue the audit requirement because "the audits for the years 2005 and beyond would cost at least one million dollars," and "the burdens of continued audits clearly outweigh

> any possible benefits." We find this contention unpersuasive. The Commission specifically found that "the audit requirement establishes an efficient and cost-effective mechanism for providing reasonable assurance of Bell Atlantic/GTE's compliance with the conditions." Verizon has not provided substantial evidence to contradict this finding. We conclude that, therefore, Verizon has not demonstrated that discontinuing the independent auditor condition would serve the public interest.[254]

5.8. The Board should seek information from the industry so that it can fulfill its mandate to prevent improper cross-subsidization.

Through its general supervisory authority and mandate to ensure that rates are just and reasonable, and to comply with New Jersey's statutory prohibition on improper cross-subsidization, the Board should issue a detailed data request to Verizon and to cable companies. These questions should seek information about the personnel, plant, and any other resources that are shared among the incumbent's basic operations and its new lines of business.

The Board should also direct Verizon and incumbent cable operators to submit cost allocation manuals and comprehensive financial statements about their operations. Furthermore, the Board should obtain a list of all intrastate regulated tariffed services upon which Verizon's cable-telco bundles rely, and a description of the method of compensation, if any, to Verizon NJ's intrastate regulated services. Verizon NJ should be directed to describe fully all network, personnel, advertising and other resources of Verizon NJ's intrastate regulated operations upon which Verizon's FiOS operations rely and to describe the method of compensation to Verizon NJ's intrastate regulated services.

Verizon and the incumbent cable operators also should provide detailed annual information for the past five years, and on an ongoing basis, about their investment in and quantities of employees assigned to their basic services to enable the Board to assess whether they are investing sufficiently to provide adequate service to households and businesses in New Jersey.

[254] / *In the Matter of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee, for Consent to Transfer of Control of Domestic and International Sections 214 and 310 Authorizations and Application to Transfer Control of a Submarine Cable Landing License*, FCC CC Docket No. 98-184, EB File No. EB-04-IH-0143, *Order*, released January 7, 2005, paras. 7-8, footnotes omitted.

6. CONCLUSION

The convergence of cable and telco services may yield consumer benefits in the form of lower rates, higher service quality, and product innovation. Presently, however, market forces do not constrain the pricing of noncompetitive services. Neither the existing interstate price cap system nor the existing intrastate *PAR-2* regulation yields rates and service quality that would prevail in a competitive market. Therefore, during the transition to effective competition, regulatory oversight and intervention are essential to ensure that basic cable rates do not subsidize entry into the phone business and to ensure that basic phone rates do not subsidize entry into the cable business. At a minimum, tools for monitoring cost accounting and allocation are essential to protect consumers of monopoly (or near-monopoly) cable and telco services from footing the bill for the industry's entry into new markets. Structural safeguards are essential to prevent improper cost allocation and to ensure that consumers benefit from innovation, service quality, just and reasonable rates, and diverse supply as New Jersey builds its information network.

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