

**BEFORE THE PUBLIC UTILITIES COMMISSION  
OF THE STATE OF CALIFORNIA**

**In the Matter of the Joint Application of  
Verizon Communications Inc. (“Verizon”)  
and MCI, Inc. (“MCI”) to Transfer Control  
of MCI’s California Utility Subsidiaries to  
Verizon, Which Will Occur Indirectly as a  
Result of Verizon’s Acquisition of MCI**

Application No. 05-04-020  
(Filed April 21, 2005)

**OPINION OF THE ATTORNEY  
GENERAL ON COMPETITIVE  
EFFECTS OF PROPOSED MERGER  
OF VERIZON COMMUNICATIONS,  
INC. AND MCI, INC.**

**PUBLIC VERSION**

**BILL LOCKYER**  
Attorney General of the State of California  
**RICHARD M. FRANK**  
Chief Deputy Legal Affairs  
**TOM GREENE**  
Chief Assistant Attorney General  
**KATHLEEN FOOTE**  
Senior Assistant Attorney General  
**LINDSAY BOWER**  
Deputy Attorney General  
**QUYEN D. TOLAND**  
Deputy Attorney General  
455 Golden Gate Avenue, Suite 11000  
San Francisco, CA 94102  
Telephone: (415) 703-5500

**Attorneys for the State of California**

## **INTRODUCTION**

This proposed merger is between the nation's largest Bell Operating Company ("BOC"), Verizon Communications, Inc. ("Verizon"), and the country's second largest long-distance phone company, MCI, Inc. ("MCI"). Announcement of this merger came on the heels of SBC Communications' \$16 billion acquisition of AT&T. As such, many in the industry see the passing of MCI and AT&T, once industry icons, as a new era in telecommunications in which competition arises not just from other phone companies, but also from new technologies. These new technologies, such as the Internet, wireless, cable, and satellite, are blurring the distinction between local and long distance.

The acquisition of MCI by Verizon is not unopposed. In this proceeding, the Office of Ratepayer Advocates (ORA) and The Utility Reform Network (TURN) contend that the merger will adversely affect competition within nearly every relevant market in which the applicants both operate. Other intervenors have raised more specific objections. In proceedings before the Federal Communications Commission, however, opponents have primarily focused upon the effects of the merger on special access services used to connect large business users to long distance lines, wireless companies' mobile transport switching offices (MTSOs), and other local facilities.

We do not find, however, that this merger will adversely affect competition in the special access services market, in particular, the markets for two types of special access: DS1 and DS3 services. We also find that competitive effects in properly-defined markets for other relevant products – including those for mass market local and long distance, "enterprise," and Internet backbone services – will be minimal.

On the other hand, we are skeptical that this merger, as structured, would yield the great merger-related efficiencies that Verizon and MCI claim. We are also concerned that the way this merger is structured could give the two companies the incentive to engage in cross-subsidizations between Verizon affiliates (MCI subsidiaries) unregulated by the CPUC and its CPUC-regulated affiliates, resulting in harm to ratepayers. We thus caution the CPUC to closely scrutinize Verizon's post-merger transactions for such occurrences.

### **I. PRIOR PROCEEDINGS AND THE NATURE OF THIS OPINION**

#### **A. Section 854(b)**

The merger between Verizon and MCI is to be accomplished through an exchange of stock of the two companies, with MCI becoming a wholly-owned subsidiary of Verizon. MCI's shareholders will receive 0.4062 shares of Verizon common stock and \$2.75 cash for every share owned of MCI. In addition, MCI shareholders will receive a special dividend in the amount of \$5.60 per share, less any dividend paid by MCI between February 14, 2005,

and the consummation of the transaction.<sup>1</sup> Although they view this acquisition as an indirect transfer of control of the MCI's certificated entities through the merger of one telecommunications holding company with another holding company, and not as an acquisition of or by a public utility within the meaning of California Public Utilities Code section 854(b),<sup>2</sup> the applicants have submitted the transaction to PUC review under the criteria set forth in that provision, as directed by the Commission in its June 30, 2005 ruling.<sup>3</sup> The CPUC has also requested the Attorney General's analysis of the competitive impact of this merger pursuant to section 854(b) of the California Public Utilities Code.

## **B. This Advisory Opinion**

This is the seventh opinion letter submitted by this office under the 1989 amendments to Section 854. Public Utility Code section 854 refers to the opinion as advisory.<sup>4</sup> Consequently this document does not control the PUC's finding under section 854, subdivision (b)(3). However, the Attorney General's advice is entitled to the weight commonly accorded an Attorney General's opinion.<sup>5</sup>

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<sup>1</sup> Joint Application of Verizon Communications Inc. and MCI, Inc., *In the Matter of the Joint Application of Verizon Communications Inc. and MCI, Inc.*, A. No. 05-04-020 (PUC April 21, 2005) ("PUC Application") at 10.

<sup>2</sup> The applicants contend that the reasoning of the *SBC/Telesis Merger Decision* is not applicable to this transaction. In that proceeding, the Commission agreed "that the plain language of subsection (b) is clear, and applies where a utility of a specified financial size is a party to the proposed transaction." Nevertheless, the Commission chose to "pierce the corporate" veil because Pacific Bell "represented over 90% of the assets of the acquired firm." Here, the applicants contend first that the MCI California subsidiaries do not account for a majority of the acquired firm in this transaction, and second, that none of the MCI subsidiaries that are certificated as public utilities has California revenues in excess of \$500 million. PUC Application at 15-16.

<sup>3</sup> *Id.* at 3. Scoping Memo and Ruling of Assigned Commissioner, dated June 30, 2005, *In the Matter of the Joint Application of Verizon Communications Inc. and MCI, Inc.*, A. No. 05-04-020 (PUC April 21, 2005).

<sup>4</sup> Section 854(b) provides in pertinent part:

Before authorizing the merger, acquisition or control of any electric, gas, or telephone utility organized and doing business in this state . . . , the commission shall find that the proposal does all of the following:

(1) Provide short-term and long-term benefits to ratepayers.

(2) Equitably allocates, where the commission has ratemaking authority, the total short-term and long-term forecasted economic benefits, as determined by the commission, of the proposed merger, acquisition, or control, between shareholders and ratepayers. Ratepayers shall receive not less than 50 percent of those benefits.

(3) Not adversely affect competition. In making this finding, the commission shall request an advisory opinion from the Attorney General regarding whether competition will be adversely affected and what mitigation measures could be adopted to avoid this result.

<sup>5</sup> See, e.g., *Moore v. Panish* (1982) 32 Cal.3d 535, 544 ("Attorney General opinions are generally accorded great weight"); *Farron v. City and County of San Francisco*, (1989) 216 Cal.App.3d 1071.

### **C. Evidentiary Basis of This Opinion**

During the course of our review, we held numerous discussions with the parties and obtained substantial materials from them pertaining to the issues discussed. We also reviewed testimony filed in these proceedings, along with various pleadings and testimony filed in the parallel Federal Communications Commission (FCC) proceedings. Additional information was obtained from other members of the industry and from staff of other governmental agencies. We have also relied upon Professor Frank Wolak, from the Department of Economics of Stanford University, to obtain further background information and a better understanding of the industry.

## **II. THE MERGER**

The proposed merger would create the second largest telecommunications company in the United States. Verizon is one of the world's largest telephone companies, with 2004 revenues of approximately \$71.3 billion.<sup>6</sup> MCI is the nation's second largest long distance company, with revenues in 2004 of approximately \$21 billion. Both companies view this acquisition as a strategic response to the convergence of telecommunications services that has occurred nationally and in California.

### **A. Overview of Verizon**

Domestically, Verizon offers local and long distance voice and data services to residential and businesses in 29 states and Washington D.C., encompassing the former Bell Atlantic and GTE territories.<sup>7</sup> Its domestic telecommunications segment provides exchange telecommunications services, including switched local residential and business services, local private line, voice and data services and Centrex services.<sup>8</sup> Verizon subsidiaries also provide intraLATA and interLATA toll and interexchange services, as well as switched and special access services to consumers, businesses and other communications carriers.<sup>9</sup> The company has been able to offer long distance services in its service territories since 2003.<sup>10</sup> Its long distance network is mainly concentrated in its local service areas and in some densely populated areas of the United States outside of its

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<sup>6</sup> Verizon Communications Inc. Annual Report on Form 10-K, December 31, 2004, attached to PUC Application.

<sup>7</sup> *Id.*

<sup>8</sup> Declaration of Timothy J. McCallion, ¶ 8, attached to CPUC Application.

<sup>9</sup> *Id.*

<sup>10</sup> [http://www.fcc.gov/Bureaus/Common\\_Carrier/in-region\\_applications/](http://www.fcc.gov/Bureaus/Common_Carrier/in-region_applications/).

service area.<sup>11</sup> Verizon does not have a nationwide long distance network; it purchases wholesale long distance services from other carriers to provide long distance services to its customers.<sup>12</sup> In addition, Verizon owns 55% of Verizon Wireless, a joint venture with Vodafone Group Plc (“Vodafone”).<sup>13</sup> Verizon Wireless provides wireless voice and data services, as well as wireless equipment.<sup>14</sup> Verizon’s other domestic subsidiaries provide information services including directory publishing and electronic commerce.<sup>15</sup> Verizon’s international subsidiaries provide and invest in wireline and wireless communications.<sup>16</sup>

## B. Overview of MCI

MCI is one of the world’s leading global communications companies, providing services in more than 200 countries.<sup>17</sup> MCI offers telecommunications services through three business segments defined by its customer base: enterprise, U.S. Sales and Service, and international and wholesale.<sup>18</sup> Its enterprise segment comprises Fortune 1000 companies, mainly large business customers with complex communications needs, government, and institutional accounts. The company’s U.S. Sales and Service segment includes large and medium businesses, and residential and small businesses, which MCI refers to as the “mass market.” MCI’s international and wholesale segment provides services to overseas customers and wholesale customers.

In terms of services and facilities, MCI provides interLATA and intraLATA long-distance service to business, residential and wholesale customers.<sup>19</sup> In addition to voice

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<sup>11</sup> Reply Declaration of Robert F. Pilgrim, Joint Opposition of Verizon Communications Inc. and MCI, Inc. to Petitions to Deny and Reply to Comments Before the FCC, *In the Matter of Verizon Communications Inc. and MCI, Inc.* WC Docket No. 05-75 (F.C.C. May 24, 2005) (“Pilgrim Reply Decl.”) at ¶3.

<sup>12</sup> *Id.* at ¶4.

<sup>13</sup> Declaration of Daniel L. Rubinfeld, attached to PUC Application (“Rubinfeld Decl.”) at ¶22.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> MCI, Inc. Annual Report in Form 10-K, December 31, 2004, attached to PUC Application at 2.

<sup>18</sup> Rubinfeld Decl. at ¶16.

<sup>19</sup> Declaration of Margaret C. Hallbach attached to PUC Application (“Hallbach Decl.”), at ¶¶ 5-8.

services, MCI provides SONET private lines, ATM, and frame relay.<sup>20</sup> It maintains an extensive Internet Protocol (“IP”) backbone over which it offers large enterprise customers a comprehensive portfolio of IP-based services, including Virtual Private Networks (“VPN”), web hosting, web conferencing, e-mail, and Voice Over IP (“VOIP”).<sup>21</sup> MCI owns the Skytel Corporation (“Skytel”), which provides various one-way numeric and alpha-numeric messaging services, two-way interactive messaging, and wireless e-mail on handheld wireless devices,<sup>22</sup> but does not have a mobile wireless service offering in its portfolio.

In California, MCI has local fiber networks in the Los Angeles, San Francisco-Oakland-San Jose, Bakersfield, Fresno, Sacramento, San Diego, and Stockton metropolitan areas.<sup>23</sup> The company has focused its construction of its local fiber network in areas where there is a high demand for services, such as large office buildings, corporate headquarters, campuses, and hotels.<sup>24</sup> MCI has approximately 1,100 “on-net” buildings in California, in which the company can serve customers entirely over its own facilities.<sup>25</sup> Within the Verizon California territory, MCI has [ ] [Confidential] “on-net” buildings.<sup>26</sup> MCI uses its local fiber networks to connect enterprise and wholesale customers in the state to its long-haul voice, data, and IP networks. It also uses its networks to provide local private line, special access, and frame relay services to its business and wholesale customers.<sup>27</sup> The company offers switched local voice services to business customers using its Class 5 circuit switches associated with its local network.<sup>28</sup>

MCI provides its mass market customers (the residential and small business customers) primarily with local and long distance voice services, usually bundled together into a single, combined product. It also provides DSL to a limited number of customers.

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<sup>20</sup> Rubinfeld Decl. at ¶17.

<sup>21</sup> *Id.*

<sup>22</sup> Hallbach Decl. at ¶9.

<sup>23</sup> *Id.* at ¶12.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> Data provided by Verizon and MCI attorneys at a September 7, 2005 meeting at the California Attorney General’s Office in San Francisco.

<sup>27</sup> Hallbach Decl. at ¶13.

<sup>28</sup> *Id.*

MCI does not offer facilities-based local mass market services; it provides the local component of these services through leased loops, transport, and switching, initially through the use of UNE-P at regulated rates, but more recently via commercial agreements with Qwest, SBC, and BellSouth.<sup>29</sup>

### C. The Purpose of the Merger

The Applicants see this merger as a strategic response to fundamental changes in demand and supply of telecommunications services and expects it to bring substantial cost savings and benefits to consumers and businesses. Changes in technology and regulation are altering the competitive landscape for wireline services. Residential and business demand for traditional wireline services is in decline nationally: average revenue per minute for wireline long distance services has fallen and the average prices received by carriers for long distance services have also fallen.<sup>30</sup> A similar trend is happening in California, as subscribership for local residential and small business lines have been decreasing steadily from 2000 to 2004.<sup>31</sup>

Both Verizon and MCI have experienced declines in wireline revenues.<sup>32</sup> Local service revenues for Verizon declined 4.8% in 2004 and 4.0% in 2003 due to lower demand and usage of basic local exchange and accompanying services.<sup>33</sup> Its network access revenues also declined 3.8% in 2004 and 5.3% in 2003 due to decreasing switched minutes of use (“MOUs”) and access lines, as well as price reductions mandated by federal and state price cap filings and other regulatory decisions.<sup>34</sup>

In recent years, MCI and other major wireline long distance carriers have experienced steep declines in wireline revenues. MCI’s wireline revenue fell by 45% between 2001 and 2004 and is expected to fall 10 to 14% in 2005.<sup>35</sup> This is due to competition, technological developments, court and FCC decisions invalidating

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<sup>29</sup> *Id.* at ¶¶16, 27.

<sup>30</sup> Prices received by carriers for long distance services have fallen by 30 percent for residential customers and by 76 percent for business customers between 1999 and 2004. See Declaration of Gustavo E. Bamberger, Dennis W. Carlton, and Allan L. Shampine, attached to *In the Matter of Verizon Communications Inc. and MCI, Inc.* WC Docket No. 05-75 (F.C.C. May 24, 2005) (“Bamberger/Carlton Decl.”) at ¶18.

<sup>31</sup> Rubinfeld Decl. at ¶¶102-103.

<sup>32</sup> *Id.* at ¶¶18, 26.

<sup>33</sup> Verizon Communications Inc. 2004 Annual Report, attached to PUC Application, at 20.

<sup>34</sup> *Id.*

<sup>35</sup> Bamberger/Carlton Decl., at ¶11.

regulations that enabled MCI to provide local service using UNE-P at “total element long run incremental cost” (“TELRIC”) based rates, as well as the “Do Not Call” legislation that restricted the amount of telemarketing that the company could do to promote its services.<sup>36</sup> MCI thus has cut back significantly its efforts to attract mass market customers: it has reduced its sales efforts and raised residential services prices, stopped mass media advertising to mass market customers, and cut back significantly its telemarketing efforts.<sup>37</sup>

Meanwhile, convergence in the communications industry is making it possible to provide once-disparate services and features, including voice, data, video, and other communications and entertainment services, over the same network, whether that network is a traditional wireline network, or cable network, or a wireless network.<sup>38</sup> The resulting “intermodal competition” or “cross-platform competition” from cable and wireless providers, as well as emerging technologies, is an important competitive dynamic facing the traditional wireline telephone companies.

This merger, therefore, represents a response to these shifts in technology and consumer demand happening in the industry. Thus, the applicants emphasize the complementary nature of their operations in terms of geographical reach, the extent of wireless offerings, and customer base.<sup>39</sup> Consumers and business alike will benefit from the merged company’s enhanced deployment of broadband services because the combination of MCI’s Internet backbone with Verizon’s deployment of fiber will result in a platform to support a wide array of multimedia communications services that will compete with the converged voice, data, and video offerings of the cable companies.<sup>40</sup>

### **III. DEFINITION OF THE RELEVANT MARKETS**

In analyzing the competitive effects of this merger, we employ the approach embodied in the antitrust laws, including the Department of Justice and Federal Trade Commission 1992 Horizontal Merger Guidelines and the April 8, 1997 revisions (the “Guidelines”). Following traditional analysis, the Guidelines analyze the effect of a consolidation upon the “relevant markets” within which the parties do business. A relevant market is described in terms of its product and geographic dimensions.

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<sup>36</sup> Hallbach Decl. at ¶18.

<sup>37</sup> *Id.* at ¶¶28-31.

<sup>38</sup> Rubinfeld Decl. at ¶¶31-32. See also Jonathan E. Nuechterlein and Philip J. Weiser, *Digital Crossroads, American Telecommunications Policy in the Internet Age*, MIT Press 2005, pp. 23-26.

<sup>39</sup> Bamberger/Carlton Decl. at ¶32.

<sup>40</sup> *Id.* at ¶170.

The product market refers to the range of products or services that are or could easily be made relatively interchangeable,<sup>41</sup> so that pricing decisions by one firm are influenced by the range of alternative suppliers available to the purchaser. These substitutes include the supply of “uncommitted entrants” not currently selling in the relevant product but that could enter within one year without incurring significant sunk costs.<sup>42</sup> The Guidelines define “sunk costs” as “the acquisition costs of tangible and intangible assets that cannot be recovered through the redeployment of these assets outside the relevant market, i.e., costs uniquely incurred to supply the relevant product and geographic market.”<sup>43</sup> The analysis then proceeds to a determination of the relevant geographic market, which is defined as the area in which the sellers compete and in which buyers can practicably turn for supply.

To avoid speculation, we provisionally define the relevant products in this merger as those services currently supplied by both of the applicants. The most important of these are local exchange and (switched) access, long distance, special access, other business applications, and Internet backbone services. Following the FCC, we also group products by their source of demand. The analysis is further refined by considering, in some instances, the “vertical” extent of the product market. Potentially adverse unilateral or coordinated effects that may result from the merger are normally considered separately from the market definition process. In some instances, however, how the market is described depends upon the theory under which competitive effects are assessed.

A product market has both “horizontal” as well as “vertical” dimensions. While the horizontal dimension encompasses close substitutes for the products supplied by the merging parties, the vertical dimension includes a range of inputs that may be more limited than the endproduct itself. For example, where an endproduct combines two inputs, one of which is competitively-supplied or “readily attainable” the appropriate level of analysis is the market

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<sup>41</sup> The Justice Department and the courts apply slightly different standards to determine the range of supply substitutes to be included within the relevant market. The courts generally include supply substitutes within the relevant market but they sometimes “include the products to which firms selling the particular product could substitute in supply, rather than, or in addition to, the products produced by firms that do not currently sell the particular product but that could begin doing so by substituting in supply.” Werden, *Market Delineation under the Merger Guidelines: a Tenth Anniversary Retrospective*, 38 Antitrust Bull. 517, 525-26 (1993).

The *DOJ/FTC Merger Guidelines* distinguish between “uncommitted entrants” and other types of “supply responses.” Thus, the Guidelines include within the relevant market those “potential competitors” which could shift their facilities “easily and economically” to sell in the relevant market within one year in response to a hypothetical price increase. *DOJ/FTC Merger Guidelines* at §§1.3, 3.0 n.25. Future supply effects are considered separately. See Werden, *supra*, at 525, 529 (“the Guidelines’ definition of an antitrust market reflects the separation of demand substitutability . . . from supply substitutability and entry, which are considered in later steps in the analysis.”)

<sup>42</sup> Guidelines §1.32.

<sup>43</sup> Guidelines §1.32

for the complementary input.<sup>44</sup> We conclude that because there are numerous suppliers of resold UNE-P telephone services, the relevant market for analyzing the effects of the merger on local exchange services is at the facilities-based level where suppliers own at least their own switches.

Likewise, because there appear to be many suppliers of wholesale fiber rings within each California wire center in which MCI provides fully-integrated, "Type I"<sup>45</sup> special access services as well as many downstream providers at the "retail" level, the relevant market for assessing the effects of the merger on special access customers is limited to suppliers of the fiber laterals that connect rings to the buildings themselves. The relevant special access markets in which MCI only provides services at "upstream" levels are discussed more fully below.

In many instances, buyers with similar demand characteristics must also be aggregated.<sup>46</sup> Bilateral and other transactions involving limited numbers of buyers and sellers are not markets, and neither price theory nor the Guidelines make predictions about such behavior. Following the Guidelines, the FCC determines a relevant product market by considering whether, "if, in the absence of regulation, all carriers raised the price of a particular service or group of services, customers would be able to switch to a substitute service offered at a lower price."<sup>47</sup> Relevant products defined by rigid adherence to this process would, however, include "each point to point calling route"<sup>48</sup> in the case of local and long distance services and every building or fiber lateral in the case of special access services.<sup>49</sup> Accordingly, the FCC aggregates all customers within a hypothetical product

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<sup>44</sup> *In re Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corp. to WorldCom, Inc.*, Memorandum Opinion and Order 13 FCC Red. 18,025 (1998) ("*WorldCom/MCI*") ¶28.

<sup>45</sup> "A Type I circuit is provisioned entirely 'on-net,' i.e., it connects two on-net buildings using only MCI fiber...[a] Type II circuit connects an on-net building to an off-net building. Most of the circuit is provisioned using MCI's local fiber, but a small piece is provisioned using the facilities of another local carrier-typically, an incumbent LEC special access 'channel termination' that extends MCI's network to the off-net building. A Type III circuit uses two incumbent LEC channel terminations, to reach an off-net building at each end of the circuit, and MCI fiber in the 'middle.' A Type IV circuit uses no MCI facilities; it is simple resale of an incumbent LEC special access circuit." Reply Declaration of Jonathan P. Powell, et al, attached to Joint Opposition of Verizon Communications Inc. and MCI, Inc. to Petitions to Deny and Reply to Comments Before the FCC, *In the Matter of Verizon Communications Inc. and MCI, Inc.* WC Docket No. 05-75 (F.C.C. May 24, 2005) ("Powell Reply Decl.") at ¶¶8-9.

<sup>46</sup> *In re Applications NYNEX Corp. & Bell Atl. Corp.*, Memorandum Opinion and Order, 12 FCC RCd. 19985 (1997) ("*Bell Atlantic/NYNEX*") ¶54.

<sup>47</sup> *Bell Atlantic/NYNEX*, ¶51.

<sup>48</sup> *Id.*

<sup>49</sup> See *Double D Spotting Service, Inc. v. Supervalu, Inc.*, 136 F.3d 554, 560-561 (8<sup>th</sup> Cir. 1998). In that case, the plaintiff alleged anticompetitive conduct within an alleged market "for unloading services at the Supervalu, Inc. warehouse in Urbandale, Iowa." At issue was "one contract between one warehouse owner and one unloading service provider." Rejecting the alleged geographic market as too narrow to support an antitrust claim, the court noted that the

market facing the same competitive alternatives<sup>50</sup> and recognizes two customer groups with similar demand patterns: first, residential and small businesses (“mass market”); and second, large businesses and government (“enterprise”) users.<sup>51</sup>

Both of the applicants sell local, long distance, Internet backbone services, and special access and other large business applications. Aggregating customers with similar demand characteristics, we find that relevant markets exist for residential and small business (“mass market”) local and long distance services and for business applications sold to medium- to large-business and government (“enterprise”) customers. We also find that a relevant market for Internet backbone services can be defined. In addition, because of their importance and standardized dimensions, we find that separate relevant markets exist for the various special access services sold by the applicants.

#### **IV. COMPETITIVE EFFECTS ANALYSIS**

The Guidelines recognize that mergers may have unlawful effects if they either facilitate coordinated interactions among competitors or enable the surviving entity to unilaterally raise prices or suppress output. A merger has unilateral effects, for example, if it results in, or strengthens the position of, a dominant firm competing with "fringe" suppliers. It can be shown that the ability of such a dominant firm to raise prices above marginal cost (its market power) is related to the sum of square of the market shares of all industry suppliers (the Herfindahl-Hirschman Index, or “HHI”), whose calculation is central to the Guidelines analysis. Adverse unilateral effects may also result from mergers where the parties’ products are so slightly differentiated or sufficiently "adjacent" that some or all of the sales loss due to the price increase of one product will be diverted to the product of the merger partner.<sup>52</sup> Likewise, a merger may be illegal if it strengthens the ability of the surviving firm to successfully engage in tacit or express collusion or other forms of coordinated interactions that are harmful to consumers.<sup>53</sup>

The Guidelines require that changes in the HHI be calculated as an analytic “starting point” in all merger reviews.<sup>54</sup> The relevance of the calculation is, however, highly

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market would “seem to be more properly defined as including all warehouses within, at least the entire Des Moines, Iowa, metropolitan area, if not an even larger area.”

<sup>50</sup> *Bell Atlantic/NYNEX*, ¶53.

<sup>51</sup> *Bell Atlantic/NYNEX*, ¶53; *WorldCom/MCI*, ¶24.

<sup>52</sup> Guidelines, at §2.21.

<sup>53</sup> Guidelines, at §2.1.

<sup>54</sup> Guidelines, at §2.0.

dependent upon the structure of the industry, how rapidly it is changing, and the theory of competitive effects. The HHI is relatively useful, for example, in assessing mergers in static, dominant-firm industries. It is less useful in predicting effects in regulated or highly dynamic industries or in mergers between firms supplying differentiated products. The Guidelines also recognize that “committed entry” by firms facing significant sunk costs can “deter an anticompetitive merger in its incipency, or deter or counteract the competitive effects of concern.”<sup>55</sup>

In this proceeding, the applicants’ market shares in all of the relevant markets need not be precisely determined. Verizon has a relatively minor presence in the relevant markets for both mass market (facilities-based) long distance and enterprise services, MCI dominates neither of those highly competitive industries, and entry barriers there are relatively minor. Similarly, MCI has a nominal share of the relevant market(s) for facilities-based local exchange services, and its absence will have inconsequential effects on price and output levels. Finally, the merger will not adversely affect competition for the DS1 and DS3 special access services supplied to enterprise customers.

#### **A. Mass Market Local Exchange**

In *WorldCom/MCI*, the FCC excluded competitively supplied inputs from the relevant market to better focus on the commercial level at which critical supply constraints could be assessed. The merger united a long distance retailer, MCI, with a wholesale supplier, WorldCom. Rather than analyze the merger at either of those levels, the Commission assessed competition in the relevant market for transmission capacity because “once a firm has overcome the barrier of deploying a national fiber network, all the other capabilities necessary to provide wholesale services are readily available.”<sup>56</sup>

The same principle is applicable here. MCI does not offer facilities-based local mass market services.<sup>57</sup> MCI resells UNE-P services to [ ] [Confidential] residential local customers in Verizon’s California operating region as of January 2005, and [ ] [Confidential] customers statewide.<sup>58</sup> Many other CLECs also provide that “readily

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<sup>55</sup> *Guidelines*, at S3.0. See also *U.S. v. Baker Hughes Inc.*, 908 F.2d 981, 987 (D.C. Cir. 1990) (“In the absence of significant [entry] barriers, a company probably cannot maintain supracompetitive pricing for any length of time”); *United States v. Syufy Enterprises*, 712 F.Supp. 1386, 1401 (N.D. Cal. 1989) (“showing of absence of entry barriers ‘undermines any claim of monopoly power’”), *aff’d*, 903 F.2d 659 (9<sup>th</sup> Cir. 1990); *WorldCom/MCI*, supra, at ¶38 n.103 (“entry of new firms will mitigate any potential anticompetitive effects” of merger “with a post-merger HHI greater than 1800, but not over 3500, accompanied by a change in HHI greater than 100”)

<sup>56</sup> *WorldCom/MCI*, supra, ¶28.

<sup>57</sup> Hallbach Decl. at ¶16.

<sup>58</sup> *Id.* at ¶41.

available” service.<sup>59</sup> In addition, although we are not persuaded that the cross-elasticities of demand between wireless and landline services are particularly high at this point in time<sup>60</sup>, cable companies and other facilities-based suppliers do provide competitively-priced VOIP service within Verizon’s service territory in California.<sup>61</sup> Following the analytical framework set out in *WorldCom/MCI*, we include within the relevant product market these facilities-based UNE-L and cable suppliers, but not resellers at the competitive retail level.

Excluding resellers from the relevant market is particularly apt here because industry output levels are determined by the market conditions facing facilities-based suppliers. We are not aware of any evidence that retail margins earned by MCI and other resellers exceed competitive levels. Entry into this sector is both “timely” and “sufficient,” undoubtedly because associated fixed and sunk costs are minimal. That being the case, industry output will be determined by the supply of and demand for the “wholesale” level inputs that facilities-based suppliers provide.

Because we conclude that the relevant market is for facilities-based services, we do not consider the question of whether MCI can still be considered an active and competitive supplier of resold services. MCI testified that the change in the economics of the mass market business, due to technological and regulatory changes<sup>62</sup> in the industry, has limited

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<sup>59</sup> Verizon served [ (Confidential) ] UNE-P lines as of March 2005. Verizon Response to FCC Specification 18(a)(2).

<sup>60</sup> As the FCC has recently found, “...consumers tend to use wireless and wireline services in a complementary manner and view the services as distinct because of differences in functionality.” [footnote omitted] However, the Commission also found that although substitution between wireless and wireline services is currently limited, “it has the potential to be a substantial source of facilities-based competition in the future.”

In the Matter of Applications of MCI Wireless Services, Inc. and Cingular Wireless Corporation For Consent to Transfer Control of Licenses and Authorizations File Nos. 0001656065, *et al.* WT Docket No. 04-70; and Applications of Subsidiaries of T-Mobile USA, Inc. and Subsidiaries of Cingular Wireless Corporation for Consent to Assignment and Long-Term *De Facto* Lease of Licenses File Nos. 0001771442, 0001757186, and 0001757204 WT Docket No. 04-254; and Applications of Triton PCS License Company, LLC, MCI Wireless PCS, LLC, and Lafayette Communications Company, LLC For Consent to Assignment of Licenses File Nos. 0001808915, 0001810164, 0001810683, and 50013CWAA04 WT Docket No. 04-323, Memorandum Opinion and Order, October 26, 2004, ¶¶239, 242 (hereinafter, “*Cingular/AT&T Wireless Order*”).

<sup>61</sup> Rubinfeld Decl., ¶¶42-43,

<sup>62</sup> Until recently, the Federal Communications Commission permitted MCI and other CLECs, which were generally unable to profitably offer local services with their own facilities, to lease the entire array of unbundled network elements (“UNE-P”), including both switching and transport, from Verizon and other ILECs at so-called “TELRIC” rates. In *United States Telecom Ass’n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004)(“*USTA I*”) *cert. denied* 125 S.Ct. 313 (2004)(“*USTA I*”), however, the D.C. Circuit vacated those parts of the FCC’s *Triennial Review Order* which mandated sale of local switching at these rates. Section 251(d)(2) of the Telecommunications Act requires that ILEC services be made available to a CLEC (“unbundled”) if the failure to do so would “impair the ability of the [CLEC] to provide the services that it seeks to offer.” In *USTA II*, the D.C. Circuit overturned FCC findings that CLECs are impaired in their ability to provide mass market (i.e., residential and small business) switches on a nationwide basis, and vacated related requirements that mass market switches be made available as UNEs. On remand, the FCC determined that these requirements created “disincentives to investment” and that UNE-P services could now be competitively deployed. The FCC ordered that all ILEC obligations to offer UNE-P services at TELRIC rates be

its ability to continue being in the market indefinitely, and that it will no longer be a price leader for the residential mass market services.<sup>63</sup> Thus, the company has cut back significantly its efforts to attract mass market customers: it has reduced its sales efforts and raised residential services prices, stopped mass media advertising to mass market customers, and cut back significantly its telemarketing efforts.<sup>64</sup> At the same time, MCI has also increased the rates charged to its UNE-P customers and anticipates more rate increases in the future as the prices it has agreed to pay for leased local facilities rise over time.<sup>65</sup>

In addition to excluding resellers from the relevant product market, we also exclude from this portion of the analysis competitive effects in the high-density urban market where special access services are supplied to enterprise customers. For purposes of this discussion, we assume that the relevant geographic market roughly corresponds to the areas in which calls are “local” in nature. We assume, furthermore, that Verizon has a dominant share in all relevant markets outside these urban locations. Because the relevant market is limited to facilities-based service, market share figures derived from polls of downstream, retail customers will not reflect the state of competition at the relevant wholesale market level. We conclude that because concentration levels will be affected only marginally by the incorporation into Verizon of MCI facilities-based services, the merger will not have adverse effects upon competition in those local markets in which MCI does not offer special access service to private line customers.

## **B. Mass Market Long Distance**

MCI is a facilities-based provider of long distance services, while Verizon supplies its long distance customers through resale operations. Accordingly, the *WorldCom/MCI* distinction between inputs that are “readily available” and those that may not be fully competitive is applicable to the analysis of the effects of this merger on long distance services.

The FCC has repeatedly determined that competition among long distance suppliers is both substantial and national in scope. AT&T, MCI, and Sprint served the vast majority of the market when the FCC found for the first time in 1995 that it was “structurally competitive.”<sup>66</sup> Since then, numerous alternative facilities-based providers have emerged,

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phased out by 2006. See *In re Unbundled Access to Network Elements*, Order on Remand, WC Dkt. No. 04-313, CC Dkt. No. 01-338, 2005 WL 289015, at ¶204 (“TRRO”).

<sup>63</sup> Hallbach Decl. ¶27.

<sup>64</sup> *Id.* at ¶¶28-31.

<sup>65</sup> *Id.* at ¶¶27, 31.

<sup>66</sup> Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, 11 FCC Rcd 3271 (1995).

and industry capacity has increased six-fold. During one three-year period, average revenues per minute dropped by 35 percent, from eleven cents to seven cents. The FCC concluded in the 2005 Triennial Review Remand Order that the market was “competitive.”<sup>67</sup>

The FCC has also determined that the United States is the relevant geographic market for assessing competition among long distance suppliers. In *WorldCom/MCI*, the FCC rejected a claim that capacity shortages might create different market conditions among different city pairs. No specific routes were alleged, however, and no such evidence has been presented in this proceeding. More generally, it was found that “geographic rate averaging and rate integration, price regulation of exchange access services, and the availability of interstate transport capacity cause carriers to behave similarly in each domestic point-to-point market.”<sup>68</sup> The FCC concluded that, “we are not persuaded that there are, or could be, materially different competitive conditions in a particular point-to-point market, or group of point-to-point markets, and therefore, treat the geographic market as a single, national market.”<sup>69</sup> Similarly, we reject any claims in this proceeding that there exist identifiable California “submarkets” for long distance services.<sup>70</sup>

Mirroring MCI’s resale presence in the local service market, Verizon offers long distance services to its customers (frequently bundled with local services) by purchasing wholesale long-distance services from other carriers.<sup>71</sup> Verizon does not have a national long-haul network of its own.<sup>72</sup> In 2004, Verizon (excluding Verizon Wireless) purchased approximately [ ] [Confidential] in wholesale long distance services from other carriers other than MCI, which by some estimates amount to only [ ] [Confidential] of total industry revenue.<sup>73</sup> If Verizon were to move all of the long-distance services it currently purchases from other carriers onto MCI’s network, it would not have a significant impact on those wholesale carriers.<sup>74</sup>

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<sup>67</sup> *TRRO*, at ¶ 36 n.107.

<sup>68</sup> *WorldCom/MCI*, ¶ 30.

<sup>69</sup> *WorldCom/MCI*, ¶ 31

<sup>70</sup> See Selwyn Reply Test. at 152, referring to a “mass market *in-region* long distance services.” [emphasis added] The “submarket” formulation advanced by Dr. Selwyn is “unsound:” “If the ‘outer boundaries’ of the market include only the product’s good substitutes in both consumption and production – which seems a fair reading of Brown Shoe’s reformulation of the cellophane test – then a submarket would be a group of sellers from which sellers of good substitutes in consumption or production had been excluded, and these exclusions would deprive any market-share statistics of their economic significance.” R. Posner, *Antitrust Law: An Economic Perspective* 129 (1976).

<sup>71</sup> Pilgrim Reply Decl., at ¶4.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at ¶5. Total U.S. long distance wholesale revenues in 2004 were estimated to be over \$18.5 billion.

<sup>74</sup> *Id.*

Like MCI, Verizon competes at the retail level with many alternative suppliers of mass market long distance services. Sunk costs facing new entrants at this retail level are minimal, and we are not aware of any evidence that margins in this sector are determined on anything but a competitive basis. Accordingly, we conclude that the retail services provided by Verizon are "readily available," that the relevant market is limited to facilities-based long distance services, and that the merger will have minimal effects on concentration levels. In addition, TURN's consultants have testified that the vertical integration resulting from the merger will benefit Verizon's long-distance operations.<sup>75</sup>

Nevertheless, some intervenors have argued that the vertical integration of Verizon and MCI's networks will have an anticompetitive effect in the long distance services market. The gist of their theory here is that the wholesale carriers supplying long distance service to Verizon would be disadvantaged once the company moves all of its long distance services onto MCI's network.<sup>76</sup> There are several problems with this argument. First, there is no evidence that the loss of Verizon traffic will harm these wholesale carriers. As discussed above, Verizon's purchase of wholesale long distance services is estimated to be only about 3 percent of total industry revenues. Second, as Drs. Bamberger, Carlton and Shampine have noted in another context, if the merger enables MCI and Verizon to realize efficiencies by moving traffic onto each other's networks, then the fact that other firms may be disadvantaged in this competitive process is neither surprising nor troubling.<sup>77</sup> The appropriate goal of antitrust policy is the "protection of competition, not competitors."<sup>78</sup>

#### **D. Enterprise Services**

We follow convention and broadly define the relevant product for enterprise customers to include the full array of highly differentiated advanced information services that large businesses and government users demand. These include local voice and data, long distance and international data, convergent voice and data, systems integration, and merged service. The cross-price elasticity of demand between any two of these services may be relatively low, many large business customers use these services interchangeably, and they are generally offered on a highly customized basis.<sup>79</sup> The courts and the FCC have

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<sup>75</sup> Reply Testimony of Terry L. Murray and Elizabeth R. Y. Kientzle on behalf of The Utility Reform Network, *In the Matter of the Joint Application of Verizon Communications Inc. and MCI, Inc.*, A. No. 05-04-020 (PUC April 21, 2005) ("Murray/Kientzle Reply Test.") at 172-173.

<sup>76</sup> Selwyn Reply Test. at 150-152, *see also* Murray/Kientzle Reply Test. at 173.

<sup>77</sup> Bamberger/Carlton Reply Decl. ¶92.

<sup>78</sup> *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.* (1977) 429 U.S. 477,488.

<sup>79</sup> Asked to explain the substitutability of these products in terms of the Merger Guidelines methodology, the applicants stated that based on FCC precedent, the Commission does not need to delineate specific product market boundaries, "except where there is credible evidence suggesting that there is or could be a lack of competitive performance with respect to a particular service or group of services." [Footnote omitted] Response to FCC

recognized a cognizable market for this aggregated<sup>80</sup> product (perhaps because there is not a clear break in the “chain of substitutes”<sup>81</sup>), which is also variously referred to as the large business segment of “advanced” or “enhanced” services.<sup>82</sup> The relevant geographic market is the United States because regional cost advantages are minor compared to the revenues offered by most contracts for enterprise services.<sup>83</sup>

The applicants have focused on different sectors of the enterprise services market. MCI is a leading supplier to national customers that require long distance and complex or merged services.<sup>84</sup> Verizon is a regional provider of local voice and traditional data services. Other competitors include various ILECs, long distance carriers, systems integrators, global network service providers, CLECs, cable companies, and equipment vendors.<sup>85</sup>

An internal analysis done by Verizon shows that at the end of 2004, AT&T was the largest telecommunications provider serving large enterprise and medium-sized businesses, with a 17 percent share of the revenues.<sup>86</sup> MCI was the next largest provider with 9 percent;

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Specification 2a., at 17.

<sup>80</sup> See 2 Areeda & Turner, Antitrust Law par.532b-c (discussing aggregation issues generally); U.S. v. AT&T, 524 F.Supp. 1336, 1375 (D.C. 1981) (discussing aggregation within the telecommunications equipment market).

<sup>81</sup> See *State v. Kraft General Foods, Inc.*, 926 F.Supp. 321, 333 (S.D.N.Y. 1995).

<sup>82</sup> Enhanced services “involve the use of computerized data processing in combination with a telephone service,” while basic service involve “the pure transmission capability of a communication path.” See *In re Amendment of Section 64.702*, 77 F.C.C. 384, 420 (1980)(“Computer II”). In its Computer I decision, the FCC adopted a policy of not regulating the enhanced services market. See *In re Regulatory and Policy Problems Presented by the Interdependence of Computer and Communication*, 28 F.C.C.2d 267 (1971). In 1983, the FCC extended this exemption to Information Service Providers, a category that would now include Internet service providers. After the *MFJ*, the FCC mandated in its Computer III inquiry a system of cost allocation and unbundling of basic service elements through an Open Network Architecture (“ONA”) system. See *In Re Amendment of Sections 64.702*, 104 F.C.C.2d 958 (1986), on reconsideration, 2 F.C.C.R. 3035 (1987). The Telecommunications Act supplanted the “basic” and “enhanced” services dichotomy by distinguishing between information and telecommunications services. Section 272 of the Act required that the BOCs provide interLATA information services through separate affiliates. See, e.g., *MCI/WorldCom*, at ¶72-76 (advanced services); *AT&T/BT Joint Venture*, at par.47; *U.S. v. AT&T*, 552 F.Supp. 131, 189 (D.C. 1982)(information services).

<sup>83</sup> Verizon classifies as ‘enterprise’ customers businesses (including the federal government) that are expected to spend at \$100,000 annually on communication services. MCI classifies ‘enterprise’ customers as businesses with at least 1,000 employees and multiple locations and spend at least \$2-3 million annually on telecommunications services. MCI also serves multinational businesses that spend \$2-180 million annually on telecommunications services. Responses to FCC’s May 5, 2005 Information and Document Request, Specification 1(a).

<sup>84</sup> Declaration of Eric J. Bruno and Shelley Murphy, attached to *In the Matter of Verizon Communications Inc. and MCI, Inc.* WC Docket No. 05-75 (F.C.C. May 24, 2005) (“Bruno/Murphy Decl.”) ¶17.

<sup>85</sup> *Id.* at ¶¶14-30.

<sup>86</sup> Joint Opposition of Verizon Communications Inc. and MCI, Inc. to Petitions to Deny and Reply to Comments, (“FCC Reply”) 20.

SBC and Verizon each had 7 percent, while Sprint, BellSouth, and Qwest had three to 5 percent each. An independent analysis conducted by Lehman Brothers confirmed that analysis, estimating that for 2005, AT&T's share will be 15.5 percent, SBC will have 13.1 percent, MCI will have 11.8 percent, Verizon's share will be 10.1 percent, Sprint's 5.9 percent; Qwest's 5.7 percent; BellSouth's 5.5 percent; Level 3's 1.2 percent; XO's 0.9 percent; and the rest of the industry, including systems integrators and CLECs will have 30.4 percent.<sup>87</sup> Although we lack detailed data, it appears that the industry is relatively unconcentrated. In fact, the FCC found in 1990 that the enhanced services market was "extremely competitive."<sup>88</sup> Subsequent entry by the BOCs, cable companies, and other well-financed firms further increased market competitiveness.<sup>89</sup> Additional data is required to fully assess competition within the industry, but we tentatively conclude that the merger will not cause undue increases in concentration levels.

It also appears unlikely that the merger will facilitate collusion, a concern expressed by some intervenors. To assess the likelihood of coordinated interaction, the Guidelines focus on such factors as: the availability of key information, firm and product heterogeneity, pricing or marketing practices, and the characteristics of buyers, sellers, and typical transactions.<sup>90</sup> The stability of any agreements reached and the history of coordinated conduct within the industry are also considered.<sup>91</sup>

We are not aware of any claims that competitors have a history of coordinating their conduct within the enterprise market. Coordination would, in fact, be difficult because the services offered by industry suppliers are heterogeneous, and customers "often obtain competitive prices through requests for proposals from carriers."<sup>92</sup>

Several intervenors claim, however, that the merger between Verizon and MCI will induce "mutual forbearance" with the merged SBC-AT&T company and other ILECs.<sup>93</sup> But the opportunity costs of pursuing such a strategy would be enormous and would have little chance of success. Verizon states that it is pursuing this merger to acquire MCI's national

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<sup>87</sup> *Id.*

<sup>88</sup> *People of State of Cal. v. F.C.C.*, 905 F.2d 1217, 1233 (9<sup>th</sup> Cir. 1990).

<sup>89</sup> One analyst recently reported that, "The enterprise market is becoming increasingly competitive with RBOCs, IXCs, CLECs and other carriers targeting customers . . ." Probe Group, "Control of the Enterprise Market," at 4 (June 2004).

<sup>90</sup> Guidelines, §2.1.

<sup>91</sup> Guidelines, §2.1.

<sup>92</sup> *WorldCom/MCI*, ¶ 65.

<sup>93</sup> Protest of XO Communications Services, Inc. (May 25, 2005) at 2, Protest of Qwest Communications Corp. (May 25, 2005) at 6.

and global customer base, and the facilities required to serve them. The majority of these customers require a comprehensive network – like MCI’s – that extends well beyond the Verizon region and into the service territories of SBC or other ILECs. The combined company will be ceding these customers to the many competitors in the enterprise market, along with much of the multi-billion investment in MCI, if it limits the scope of its operations to the Verizon territory it currently serves. Furthermore, through its investment in Verizon Wireless, Verizon competes directly with SBC and other ILECs for wireless customers in many of the country’s largest MSAs, highlighting the inaccuracy of the charge the Verizon and SBC have historically refused to compete within each other’s territories.

Regardless of the history of out-of-region competition and the costs of abandoning the MCI network, a forbearance strategy would have little likelihood of success. If the two surviving companies together were to dominate an industry where products were relatively homogenous and customers had little countervailing power, a mutual forbearance strategy between Verizon-MCI and SBC-AT&T might have merit. The intervenors’ depiction does not, however, capture the key features of the post-merger telecommunications market. In fact, "customers of business services are highly heterogeneous with respect to size, geography, and services demanded as well as service quality required."<sup>94</sup> They also "differ with respect to purchasing practices" and are "often highly sophisticated."<sup>95</sup>

Therefore, although additional data is required to fully assess post-merger competition in the enterprise market, we tentatively conclude that this merger will not adversely affect competition in this sector. We analyze separately the impact of this merger on special access services.

### **E. Special Access Services**<sup>96</sup>

The principle competitive issue raised by this merger is whether it will enhance the ability of the surviving firm to exercise market power over special access DS1 and DS3

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<sup>94</sup> Bamberger/Carlton Reply Decl., ¶ 66.

<sup>95</sup> *Id.*

<sup>96</sup> "Special access" refers to a dedicated point-to-point facility provided to carrier (i.e. wholesale) and non-carrier (i.e. retail) customers by ILECs and CLECs. See *Investigation of Special Access Tariffs of Local Exchange Carriers*, Memorandum Opinion and Order, 8 FCC Rcd 4712 ¶2 (1993) (Special access "primarily involves the provisioning of so-called 'private lines,' that is, facilities or network transmission capacity dedicated to the use of an individual customer.") Special access is also used to provide direct connections between two end-user locations and between end users and CLEC networks and Internet service providers; various types of carriers, including wireless providers, use special access to make connections within their own networks and to connect their networks to other carriers. See *Special Access Rates for Price Cap Local Exchange Carriers*, Order and Notice of Proposed Rulemaking, WC Docket No. 05-25, FCC 05-18, ¶3 (rel. Jan. 31, 2005) ("*Special Access NPRM*") ("[B]usiness customers, commercial mobile radio service (CMRS) providers, interexchange carriers (IXCs), and competitive LECs all use special access as a key input in many of their respective service offerings.").

services. The various markets for special access services are expanding extremely rapidly, and MCI is an important competitor for those services. Although the data we have examined is incomplete, we do not believe that post-merger, a combined Verizon and MCI will be able to exercise market power over the average rates paid for DS1 and DS3 services.

Verizon provides special access predominantly on a wholesale basis to other carriers. In 2004, the company's special access revenues totaled approximately [ ] [Confidential].<sup>97</sup> Approximately [ ] [Confidential] of this total was generated from the provision of special access to carrier customers; the remaining [ ] [Confidential] was generated from the provision of special access to non-carrier customers, primarily medium and large businesses.<sup>98</sup> Data shows that the majority of the special access that Verizon provides to wholesale and retail customers is at the DS1 and DS3 levels.<sup>99</sup>

Although MCI does not market its services as "special access," it does offer an equivalence to Verizon's special access service, called "Metro Private Line." In 2004, MCI earned approximately [ ] [Confidential] from Metro Private Line service, which came predominantly from the provision of DS1 and DS3 services.<sup>100</sup> In contrast to Verizon, [BEGIN CONFIDENTIAL] [END CONFIDENTIAL].<sup>101</sup>

We follow the FCC and conclude that the relevant geographic market for assessing these competitive effects in the special access market is at the MSA level.<sup>102</sup> Private networks are often dispersed over much wider ranges than individual wire centers encompass. As discussed above, however, rigid adherence to the Guidelines' market definition approach would include "each point to point calling route" in the case of local and long distance services and every building or fiber lateral in the case of special access services. As we also noted, bilateral and other transactions involving limited numbers of buyers and sellers are not markets, and neither price theory nor the Guidelines make

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<sup>97</sup> Verizon Response to FCC Specifications, Exhibits 5.A.3, 5.A.6, 5.C.2.

<sup>98</sup> *Id.*

<sup>99</sup> See Verizon Response to FCC Specifications, Exhibits 5.A.3, 5.A.6.

<sup>100</sup> See MCI Response to FCC Specifications, Exhibit 5(a).

<sup>101</sup> See MCI Response to FCC Specifications, Exhibit 5(a) and MCI Response to the U.S. Department of Justice for Additional Information and Documentary Material Regarding the Verizon/MCI Transaction ("MCI Response to DOJ"), Interrogatory 3.

<sup>102</sup> *In the Matter of Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Interexchange Carrier Purchases of Switched Access Services Offered by Competitive Local Exchange Carriers; Petition of U.S. West Communications, Inc. for Forebearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA, CC Docket No. 96-262; CCB/CPD File No. 98-63; CC Docket No. 98-157, Fifth Report and Order And Further Notice Of Proposed Rulemaking, August 5, 1999. ("Access Charge Reform Order"), at ¶72.*

predictions about such behavior. For these reasons, the FCC aggregates all customers within a hypothetical product market facing the same competitive alternatives.

Within the Verizon California territory, MCI provides fiber-based special access services in the Los Angeles-Long Beach-Santa Ana MSA, Santa Barbara-Santa Maria MSA, and Oxnard-Thousand Oaks-Ventura MSA. An analysis of buildings served by MCI fiber in Verizon's California territory shows that as of June 30, 2005, approximately [ ] [Confidential] buildings were connected to MCI fiber in Verizon's in-state region.<sup>103</sup> At least [ ] [Confidential] of those [ ] [Confidential] buildings are "lit" by at least one competitor other than MCI; another [ ] [Confidential] of the remaining [ ] [Confidential] buildings are located within [ ] [Confidential] of fiber deployed by competitors other than MCI, or are buildings where known customer demand is at two DS3 levels or greater.<sup>104</sup> In addition, at least [ ] [Confidential] of the [ ] [Confidential] buildings served by MCI in Verizon's California territory are located within [ ] [Confidential] of fiber deployed by competitors other than MCI, or had customer demand of least two DS3 levels or greater.<sup>105</sup> Confirming that competition is adequate for buildings that demand two DS3 or higher capacity, various other data show that an average of 19 fiber rings have been deployed in each of the top 50 MSAs.<sup>106</sup> Thus, 17 fiber wholesalers – companies that have deployed fiber to serve other CLECs and ILECs – operate in the greater Los Angeles MSA, 14 do business in the greater San Francisco MSA, and 13 provide service in the greater San Diego MSA.<sup>107</sup>

Although the above analysis does not reveal number of buildings to which MCI provides DS1 and DS3 service over non-fiber lines<sup>108</sup> within the Verizon territory, the applicants have verbally revealed to this office that fewer than [ ] [Confidential] buildings are served by MCI with copper lines within Verizon's territory, in addition to the [ ] [Confidential] cited above.

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<sup>103</sup> Data presented by Verizon and MCI at September 7, 2005 meeting with Quyen Toland, Kathleen Foote, and Frank Wolak (via conference call) at the Office of the Attorney General, San Francisco.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* The revenues available from the "large enterprise customers" that demand fiber at OCn or "two DS3s" of capacity levels generally justify the investment necessary to overcome the sometimes "quite high" fixed and sunk costs of constructing new fiber. *TRRO*, at ¶154. Thus, the FCC has found that "it is generally feasible for a carrier to self-deploy its own high-capacity loops when demand nears two DS3s of capacity to a particular location." *TRRO*, at ¶177.

<sup>106</sup> UNE Fact Report 2004, at III-3, Appendix D.

<sup>107</sup> *Id.* at Appendix D.

<sup>108</sup> In contrast to OCn, DS1 level service can be provided over conventional copper lines if certain hardware is installed at the LEC's central office. See <http://www.supertrunk.com/>.

The data above lead to a number of conclusions regarding the competitive effect of this merger on special access services. First, the data reveals that only a very small number of buildings in Verizon's California territory served by MCI are subject to any potential reduction in competition. Second, the majority of the MCI-lit buildings are in Verizon's California service areas where other CLECs operate within close proximity; this facilitates the ability of other firms to replace MCI as a competitor in serving these buildings.

Under the Merger Guidelines, potential entry is deemed sufficient "to deter or counteract the competitive effects of concern" where such entry "can be achieved within two years from initial planning to significant market impact."<sup>109</sup> In evaluating the ability of competing carriers to deploy fiber to buildings that MCI serves, it should be recognized that the competing carriers would not need to deploy new fiber rings, but only need to connect fiber "laterals"<sup>110</sup> that connect the rings to the buildings themselves. When fiber is deployed, competing carriers typically "pre-install several break-out points...to give engineers access to fiber for future lateral connections" so that lateral extensions can be added later at lower cost.<sup>111</sup> [BEGIN CONFIDENTIAL] [END CONFIDENTIAL]<sup>112</sup> [BEGIN CONFIDENTIAL] [END CONFIDENTIAL] Thus, potential entry here should be sufficient within the Merger Guidelines to counteract any potential anticompetitive effects of the merger on special access DS1 and DS3 services.

## F. Internet Backbone

Several parties challenge the integration of Verizon's Internet access services into MCI's Internet backbone without alleging specific competitive effects in markets for either of those services. We find that both of those markets are unconcentrated and will remain so after the completion of the merger.

The Internet combines three types of participants: end users, Internet service providers (ISPs), and Internet backbone providers (IBPs). "End users send and receive information; ISPs allow end users to access Internet backbone networks; and IBPs route traffic between ISPs and interconnect with other IBPs."<sup>113</sup>

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<sup>109</sup> Guidelines §§3.0, 3.2.

<sup>110</sup> A "lateral" is the "fiber-optic facility used to connect a fiber-optic ring to a particular customer location." *TRRO*, P.153, n.425.

<sup>111</sup> UNE Fact Report 2004, at III-16 [Footnotes omitted] Furthermore, "[t]he laterals themselves cost considerably less than the initial ring, because they can be buried just a few inches deep, rather than being laid in ducts." *Id.* [Footnote omitted].

<sup>112</sup> See Attachment 6, Special Access White Paper, submitted to the U.S. Department of Justice, dated July 29, 2005.

<sup>113</sup> *WorldCom/MCI*, ¶143.

Although they compete for ISP customers and larger business users, IBPs must also interconnect to offer their own end users access to other users and to websites and other content available through other IBPs.<sup>114</sup> Smaller IBPs pay other IBPs under "transit" agreements to carry their traffic, the amount depending upon the capacity of the connection. Traffic exchanged under the "peering" arrangements between larger, "Tier 1" Internet backbones, in contrast, is settlement-free; these networks do not charge each other for connectivity, but intermediate transit is not provided to non-Tier 1 IBPs.<sup>115</sup>

Verizon is a vertically-integrated ISP that also provides Internet backbone services. Its Internet backbone is used to carry traffic of Verizon's own end-user customers; it does not provide transit services to other backbone providers.<sup>116</sup> Verizon purchases transit service from Qwest and Level 3.<sup>117</sup> MCI is a Tier 1 Internet backbone service provider, but is not involved in the downstream retail broadband services market.<sup>118</sup>

In *WorldCom/MCI*, the FCC reviewed and approved a proposed divestiture of MCI's Internet backbone negotiated by the Department of Justice with the merging parties. The relevant market for assessing the effects of the divestiture was Internet backbone services, and the relevant geographic market was the United States.<sup>119</sup>

We accept the FCC's relevant market findings in this review and conclude that the backbone market will remain competitive following the completion of this merger. Employing various metrics, applicants' expert Dr. Kende showed that the post-merger market for Internet backbone will be highly unconcentrated. Revenue data indicates that MCI has a 9.1% market share while Verizon has a 5.2% share.<sup>120</sup> Measured in terms of traffic volume, MCI has approximately 7.4% share of Internet traffic in North America,

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<sup>114</sup> *Id.* at ¶144.

<sup>115</sup> *Id.* at ¶145.

<sup>116</sup> Response of Verizon to the Commission's May 5, 2005 Initial Information and Document Request, *In the Matter of Verizon Communications Inc. and MCI, Inc.* WC Docket No. 05-75 (FCC May 26, 2005), Response to Specification 8.a.5.

<sup>117</sup> *Id.*

<sup>118</sup> Reply Testimony of Lee L. Selwyn on Behalf of the Office of Ratepayer Advocates, *In the Matter of the Joint Application of Verizon Communications Inc. and MCI, Inc.*, A. No. 05-04-020 (PUC April 21, 2005) ("Selwyn Reply Test.") at p. 160.

<sup>119</sup> *Id.* at ¶148.

<sup>120</sup> Declaration of Michael Kende, attached to *In the Matter of Verizon Communications Inc. and MCI, Inc.* WC Docket No. 05-75 (F.C.C. May 24, 2005) ("Kende Decl.") at Annex A.

while Verizon has approximately 2% share.<sup>121</sup> Thus, post-merger the combined firm would account for at most only 9.5% of the total Internet traffic in North America. The combined Verizon-MCI would rank as the fourth largest Internet backbone in terms of traffic volume, with major competitors that include SBC-AT&T, Sprint, Level 3, Qwest, SAVVIS and AOL.<sup>122</sup> Furthermore, a combined Verizon-MCI together with SBC-AT&T will still have approximately 28% of Internet traffic, while the top seven backbones would carry about 65% of total Internet traffic.<sup>123</sup> Given these numbers, the combined Verizon-MCI would not have the market share necessary to successfully engage in anticompetitive activities in such an unconcentrated Internet backbone market.<sup>124</sup> We similarly find that the market for ISP services is highly unconcentrated and will remain so post-merger.

Nonetheless, several intervenors contend that combining Verizon with MCI, a Tier 1 peering provider, will raise prices for IP-based services<sup>125</sup> or induce degraded ISP access to the Internet backbone.<sup>126</sup> For example, ORA contends that after the merger, “Verizon will acquire the ability to access the Internet backbone on a peer-to-peer basis, and will avoid a significant cost that *every other retail ISP is forced to incur* [sic].”<sup>127</sup> ORA hypothesized that Verizon’s “considerable cost advantages” relative to its rivals—principally the cable companies—would allow it to engage in a predatory price squeeze that could eventually force competitors out of the market altogether.<sup>128</sup> However, ORA and the other intervenors do not explain how such an outcome is likely when both the Internet backbone and ISP markets are unconcentrated with low entry barriers.<sup>129</sup> Furthermore, the intervenors do not explain the mechanism by which many ISPs successfully competed against MCI and other vertically

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<sup>121</sup> Reply Declaration of Michael Kende, attached to Joint Opposition of Verizon Communications Inc. and MCI, Inc. to Petitions to Deny and Reply to Comments Before the FCC, *In the Matter of Verizon Communications Inc. and MCI, Inc.* WC Docket No. 05-75 (F.C.C. May 24, 2005) (“Kende Reply”) at ¶8.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> Dr. Kende also pointed out that competition for backbone services is intensifying due to a number of different factors. They include the relatively low cost of fiber, routers and other inputs required to provide backbone services, along with the availability of efficient interconnection points with other networks. These trends have placed downward pressure on transit prices and total revenues in the Internet backbone market. *Id.* at ¶¶18-29.

<sup>125</sup> *Protest of Pac-West Telecomm, Inc. (“Pac-West”),* 15

<sup>126</sup> *Id.*

<sup>127</sup> Selwyn Reply Test., at 160.

<sup>128</sup> *Id.*

<sup>129</sup> See Reiffen and Vita, *Is There New Thinking on Vertical Mergers? A Comment*, 63 Antitrust L.J. 917, 919 (1995)(where both markets are competitive, “a unilateral reduction by the integrated firm would be offset fully by out expansions on the part of nonintegrated input suppliers.”)

integrated firms when the market was considerably more concentrated than it is today.

The hypothesized motivation for the surviving firm to predatorily degrade rivals' ISP service is also unclear. As explained in a slightly different context, a firm that raises a rival's costs may improve its competitive position relative to the victim, but dilute the quality of its own product in doing so (e.g., by reducing connectivity), and thereby suffer relative to the many other suppliers that remain.<sup>130</sup> As discussed above, Dr. Kende reported that post-merger Verizon and MCI will have a combine share of Internet traffic of at most only 9.5 percent.

## **V. POST-MERGER TRANSACTIONS BETWEEN VERIZON AND NON-REGULATED AFFILIATES**

In this case, the Joint Applicants propose a merger of the parent companies of Verizon California and the MCI subsidiaries that provide service in California. Once the transaction is completed, the MCI subsidiaries in California will remain subsidiaries of MCI, some which may not be subject to CPUC jurisdiction. Furthermore, the Agreement does not call for the merger of any assets, operations, or facilities of the MCI subsidiaries with the assets, operations or facilities of any Verizon entity.<sup>131</sup> There are two concerns related to such an arrangement.

First, we are concerned that this arrangement could produce incentives for the two "independent" entities to engage in anticompetitive cross-subsidization between the MCI subsidiaries that will not be regulated by the CPUC and their CPUC-regulated parent company, Verizon. An example of an anticompetitive cross-subsidization that could occur is one in which Verizon ratepayers end up paying for purchases made by MCI at inflated prices. We advise that the CPUC use its regulatory mandate to scrutinize post-merger transactions between Verizon's regulated and non-regulated affiliates to make sure that such cross-subsidizations does not occur.

Second, we find it difficult to understand how any post-merger efficiencies can be realized if the facilities of the two companies remain separate and operated independently, rather than being combined and their capacities maximized. As this transaction is presently structured, the only change that would result from this merger is that MCI profits that once would have gone to MCI shareholders would now go to Verizon shareholders.

## **VI. CONCLUSION**

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<sup>130</sup> Bamberger/Carlton Reply Decl. at ¶87.

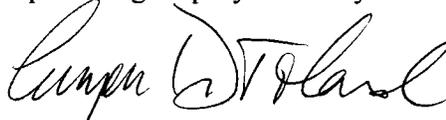
<sup>131</sup> PUC Application at 10-11.

We find that the parties do not compete in any meaningful sense in the relevant markets for facilities-based mass market services and that the merger will not significantly increase concentration levels in the competitive market for Internet backbone services. In addition, we find that the merger will not adversely affect competition in the special access services market. We are, however, concerned that the merger, as structured, may not yield the kind of efficiencies that Verizon and MCI touts in their Joint Application, and that there may be incentives for the companies to engage in post-merger transactions harmful to ratepayers absent CPUC scrutiny.

Dated: September 16, 2005

Respectfully submitted

BILL LOCKYER  
Attorney General of the State of California  
KATHLEEN FOOTE  
Supervising Deputy Attorney General

A handwritten signature in black ink, appearing to read "Quyen D. Toland". The signature is written in a cursive style with a large, stylized initial "Q".

QUYEN D. TOLAND  
Deputy Attorney General

**DECLARATION OF SERVICE**

Case Name: In the Matter of the Joint Application of Verizon Communications Inc. ("Verizon") and MCI, Inc. ("MCI") to Transfer Control of MCI's California Utility Subsidiaries to Verizon, Which Will Occur Indirectly as a Result of Verizon's Acquisition of MCI  
Application No.: 05-04-020

I declare:

I am employed in the Office of the Attorney General, which is the office of a member of the Bar of this Court at which member's direction this service is made. I am 18 years of age or older and not a party to the within entitled cause.

On September 16, 2005, I served the attached

**OPINION OF THE ATTORNEY GENERAL ON COMPETITIVE EFFECTS OF  
PROPOSED MERGER OF VERIZON COMMUNICATIONS, INC. AND MCI, INC. -  
PUBLIC VERSION**

via e-mail to the addressees whose e-mail addresses are listed on the service list attached

via regular mail to the addressees as indicated on the service list attached.

I declare under penalty of perjury under the laws of the State of California the foregoing is true and correct and that this declaration was executed on September 16, 2005, at San Francisco, California.

Sandy Shum

\_\_\_\_\_  
Typed Name



\_\_\_\_\_  
Signature

SERVICE LIST - Public

LEE L. SELWYN  
ECONOMICS AND TECHNOLOGY, INC.  
TWO CENTER PLAZA, SUITE 400  
BOSTON, MA 02108

Iselwyn@econtech.com

KATHERINE K. MUDGE  
ATTORNEY AT LAW  
COVAD COMMUNICATIONS COMPANY  
100 CONGRESS AVENUE, SUITE 2000  
AUSTIN, TX 78701

katherine.mudge@covad.com

KRISTIN L. SMITH  
QWEST COMMUNICATIONS CORPORATION  
1801 CALIFORNIA STREET, 10<sup>TH</sup> FLOOR  
DENVER, CO 80202

Kristin.Smith@qwest.com

HENRY WEISSMANN  
ATTORNEY AT LAW  
MUNGER, TOLLES & OLSON, LLP  
355 S. GRAND AVENUE, SUITE 3500  
LOS ANGELES, CA 90071-1560

henry.weissmann@mto.com

DON EACHUS  
VERIZON CALIFORNIA, INC.  
112 S. LAKE LINDERO CANYON ROAD  
THOUSAND OAKS, CA 91362

don.eachus@verizon.com

ELAINE M. DUNCAN  
ATTORNEY AT LAW  
VERIZON  
711 VAN NESS AVENUE, SUITE 300  
SAN FRANCISCO, CA 94102

elaine.duncan@verizon.com

WILLIAM NUSBAUM  
ATTORNEY AT LAW  
THE UTILITY REFORM NETWORK  
711 VAN NESS AVENUE, SUITE 350  
SAN FRANCISCO, CA 94102

bnusbaum@turn.org

NATALIE WALES  
CALIF PUBLIC UTILITIES COMMISSION  
LEGAL DIVISION  
ROOM 4107  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[ndw@cpuc.ca.gov](mailto:ndw@cpuc.ca.gov)

JAMES B. YOUNG  
ATTORNEY AT LAW  
SBC CALIFORNIA  
140 NEW MONTGOMERY STREET  
SAN FRANCISCO, CA 94105

[jy2378@sbc.com](mailto:jy2378@sbc.com)

JAMES M. TOBIN  
ATTORNEY AT LAW  
MORRISON & FOERSTER LLP  
425 MARKET STREET  
SAN FRANCISCO, CA 94105

[JTobin@mofa.com](mailto:JTobin@mofa.com)

MARIA L. WOODBRIDGE  
ATTORNEY AT LAW  
MCI, INC.  
201 SPEAR STREET, 9<sup>TH</sup> FLOOR  
SAN FRANCISCO, CA 94105

[Maria.L.Woodbridge@mci.com](mailto:Maria.L.Woodbridge@mci.com)

PATRICK S. THOMPSON  
ATTORNEY AT LAW  
PILLSBURY WINTHROP SHAW PITTMAN LLP  
50 FREMONT STREET  
SAN FRANCISCO, CA 94105

[patrick.thompson@pillsburylaw.com](mailto:patrick.thompson@pillsburylaw.com)

RICHARD B. SEVERY  
ATTORNEY AT LAW  
MCI, INC.  
201 SPEAR STREET, 9<sup>TH</sup> FLOOR  
SAN FRANCISCO, CA 94105

[richard.b.severy@mci.com](mailto:richard.b.severy@mci.com)

GLENN STOVER  
ATTORNEY AT LAW  
STOVER LAW  
301 HOWARD STREET, SUITE 830  
SAN FRANCISCO, CA 94105-6605

[glenn@stoverlaw.net](mailto:glenn@stoverlaw.net)

DAVID J. MILLER  
ATTORNEY AT LAW  
AT & T  
795 FOLSOM STREET, ROOM 3107  
SAN FRANCISCO, CA 94107

[davidjmiller@att.com](mailto:davidjmiller@att.com)

MARGARET L. TOBIAS  
ATTORNEY AT LAW  
TOBIAS LAW OFFICE  
460 PENNSYLVANIA AVE  
SAN FRANCISCO, CA 94107

[marg@tobiaslo.com](mailto:marg@tobiaslo.com)

ENRIQUE GALLARDO  
ATTORNEY AT LAW  
LATINO ISSUES FORUM  
160 PINE STREET, SUITE 700  
SAN FRANCISCO, CA 94111

[enriqueg@lif.org](mailto:enriqueg@lif.org)

JOHN CLARK  
ATTORNEY AT LAW  
GOODIN MACBRIDE SQUERI RITCHIE & DAY  
LLP  
505 SANSOME STREET, 9<sup>TH</sup> FLOOR  
SAN FRANCISCO, CA 94111

[jclark@gmssr.com](mailto:jclark@gmssr.com)

JOSE E. GUZMAN, JR.  
ATTORNEY AT LAW  
NOSSAMAN, GUTHNER, KNOX, ELLIOTT, LLP  
50 CALIFORNIA STREET, 34<sup>TH</sup> FLOOR  
SAN FRANCISCO, CA 94111

[jguzman@nossaman.com](mailto:jguzman@nossaman.com)

SARAH DE YOUNG  
CALIFORNIA ASSOCIATION OF  
COMPETITIVE  
50 CALIFORNIA STREET, SUITE 1500  
SAN FRANCISCO, CA 94111

[deyoung@caltel.org](mailto:deyoung@caltel.org)

THOMAS J. MACBRIDE, JR.  
ATTORNEY AT LAW  
GOODIN MACBRIDE SQUERI RITCHIE & DAY  
LLP  
505 SANSOME STREET, SUITE 900  
SAN FRANCISCO, CA 94111

[tmacbride@gmsr.com](mailto:tmacbride@gmsr.com)

TERRY L. MURRAY  
MURRAY & CRATTY  
P O BOX 570  
EL CERRITO, CA 94530

[tlmurray@earthlink.net](mailto:tlmurray@earthlink.net)

JOSEPH S. FABER  
ATTORNEY AT LAW  
LAW OFFICE OF JOSEPH S. FABER  
3527 MT. DIABLO BLVD., SUITE 287  
LAFAYETTE, CA 94549

[jsf@joefaber.com](mailto:jf@joefaber.com)

DOUGLAS GARRETT  
COX COMMUNICATIONS  
2200 POWELL STREET, STE. 1035  
EMERYVILLE, CA 94608

[douglas.garrett@cox.com](mailto:douglas.garrett@cox.com)

KEVIN M. KNESTRICK  
ATTORNEY AT LAW  
DISABILITY RIGHTS ADVOCATES  
449 15<sup>TH</sup> STREET, SUITE 303  
OAKLAND, CA 94612

[pucservice@dralegal.org](mailto:pucservice@dralegal.org)

ITZEL BERRIO  
ATTORNEY AT LAW  
THE GREENLINING INSTITUTE  
1918 UNIVERSITY AVENUE, 2ND FLOOR  
BERKELEY, CA 94704

[iberrio@greenlining.org](mailto:iberrio@greenlining.org)

ROBERT GNAIZDA  
ATTORNEY AT LAW  
THE GREENLINING INSTITUTE  
1918 UNIVERSITY AVENUE, 2<sup>ND</sup> FLOOR  
BERKELEY, CA 94704

[robertg@greenlining.org](mailto:robertg@greenlining.org)

RICHARD H. LEVIN  
ATTORNEY AT LAW  
3554 ROUND BARN BOULEVARD, SUITE 303  
SANTA ROSA, CA 95403

rl@comrl.com

ADAM L. SHERR  
CORPORATE COUNSEL  
QWEST COMMUNICATIONS CORPORATION  
16007 7<sup>TH</sup> AVENUE, ROOM 3206  
SEATTLE, WA 98191

adam.sherr@qwest.com

DOUGLAS R. M. NAZARIAN  
HOGAN & HARTSON L.L.P.  
555 13<sup>TH</sup> STREET, N.W.  
WASHINGTON, DC 20004

drmnazarian@hhlaw.com

ANDREW B. CLUBOK  
KIRKLAND & ELLIS LLP  
655 FIFTEENTH ST., N. W. SUITE 1200  
WASHINGTON, DC 20005

via regular mail

TARAH S. GRANT  
HOGAN & HARTSON LLP  
8300 GREENSBORO DRIVE, STE 1100  
MCLEAN, VA 22102

tsgrant@hhlaw.com

SHERRY F. BELLAMY  
VP & ASSOCIATE GENERAL COUNSEL  
VERIZON CORPORATE SERVICES  
SUITE 500  
1515 NORTH COURT HOUSE ROAD  
ARLINGTON, CA 22201

via regular mail

MARSHA A. WARD  
NATIONAL DIRECTOR  
MCI  
LAW & PUBLIC POLICY  
6 CONCOURSE PARKWAY, SUITE 600  
ATLANTA, GA 30328

via regular mail

GREG ROGERS  
DIRECTOR STATE REGULATORY AFFAIRS  
LEVEL 3 COMMUNICATIONS, LLC  
1025 ELDORADO BLVD.  
BROOMFIELD, CO 80021

[greg.rogers@level3.com](mailto:greg.rogers@level3.com)

LISA ANDERL  
QWEST COMMUNICATIONS  
1801 CALIFORNIA STREET, 10<sup>TH</sup> FLOOR  
DENVER, CO 80202

[lisa.anderl@qwest.com](mailto:lisa.anderl@qwest.com)

REX KNOWLES  
REGIONAL VICE PRESIDENT  
XO COMMUNICATIONS SERVICES, INC.  
111 EAST BROADWAY, SUITE 1000  
SALT LAKE CITY, UT 84111

[rex.knowles@xo.com](mailto:rex.knowles@xo.com)

JEREMY H. STERN  
COLE RAYWID & BRAVERMAN L.L.P.  
FIRST FLOOR, SUITE 110  
2381 ROSECRANS AVENUE  
EL SEGUNDO, CA 90245

[js Stern@crblaw.com](mailto:js Stern@crblaw.com)

ESTHER NORTHRUP  
COX CALIFORNIA TELCOM  
5159 FEDERAL BLVD.  
SAN DIEGO, CA 92105

[esther.northrup@cox.com](mailto:esther.northrup@cox.com)

MARY E. WAND  
ATTORNEY AT LAW  
MORRISON & FOERSTER LLP  
425 MARKET STREET  
SAN FRANCISCO, CA 94105

[mwand@mofocom](mailto:mwand@mofocom)

PETER HAYES  
SBC CALIFORNIA  
140 NEW MONTGOMERY ST. RM 922  
SAN FRANCISCO, CA 94105

[peter.hayes@sbc.com](mailto:peter.hayes@sbc.com)

KATY LINDSAY  
AT & T COMMUNICATIONS OF CALIFORNIA,  
INC.  
795 FOLSOM STREET, ROOM 2155  
SAN FRANCISCO, CA 94107

[klindsay@att.com](mailto:klindsay@att.com)

MARTIN A. MATTES  
ATTORNEY AT LAW  
NOSSAMAN, GUTHNER, KNOX & ELLIOTT,  
LLP  
50 CALIFORNIA STREET, 34<sup>TH</sup> FLOOR  
SAN FRANCISCO, CA 94111

[mmattes@nossaman.com](mailto:mmattes@nossaman.com)

SUSAN E. BROWN  
LATINO ISSUES FORUM  
160 PINE STREET, SUITE 700  
SAN FRANCISCO, CA 94111

[lifcentral@lif.org](mailto:lifcentral@lif.org)

SUZANNE TOLLER  
ATTORNEY AT LAW  
DAVIS WRIGHT TREMAINE  
ONE EMBARCADERO CENTER, SUITE 600  
SAN FRANCISCO, CA 94111

[suzannetoller@dwt.com](mailto:suzannetoller@dwt.com)

DAVID J. MARCHANT  
ATTORNEY AT LAW  
DAVIS WRIGHT TREMAINE LLP  
ONE EMBARCADERO CENTER, STE. 600  
SAN FRANCISCO, CA 94111-3834

[davidmarchant@dwt.com](mailto:davidmarchant@dwt.com)

EARL NICHOLAS SELBY  
ATTORNEY AT LAW  
LAW OFFICES OF EARL NICHOLAS SELBY  
418 FLORENCE STREET  
PALO ALTO, CA 94301

[ens@loens.com](mailto:ens@loens.com)

ANITA TAFF-RICE  
ATTORNEY AT LAW  
1547 PALOS VERDES MALL, 298  
WALNUT CREEK, CA 94597

[anitataffrice@earthlink.net](mailto:anitataffrice@earthlink.net)

MELISSA W. KASNITZ  
ATTORNEY AT LAW  
DISABILITY RIGHTS ADVOCATES  
449 15<sup>TH</sup> STREET, SUITE 303  
OAKLAND, CA 94612

[pucservice@dralegal.org](mailto:pucservice@dralegal.org)

LOS ANGELES DOCKET OFFICE  
CALIFORNIA PUBLIC UTILITIES  
COMMISSION  
320 W. 4<sup>TH</sup> STREET, SUITE 500  
LOS ANGELES, CA 90013

[LAdockets@cpuc.ca.gov](mailto:LAdockets@cpuc.ca.gov)

QUYEN D. TOLAND  
DEPUTY ATTORNEY GENERAL  
DEPARTMENT OF JUSTICE  
455 GOLDEN GATE AVENUE, SUITE 11000  
SAN FRANCISCO, CA 94102

[Quyen.Toland@doj.ca.gov](mailto:Quyen.Toland@doj.ca.gov)

ARAM SHUMAVON  
CALIF PUBLIC UTILITIES COMMISSION  
EXECUTIVE DIVISION  
ROOM 5306  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[sap@cpuc.ca.gov](mailto:sap@cpuc.ca.gov)

BERLINA W. GEE  
CALIF PUBLIC UTILITIES COMMISSION  
LEGAL DIVISION  
ROOM 5040  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[bwg@cpuc.ca.gov](mailto:bwg@cpuc.ca.gov)

DENIEL SEAMANS  
CALIF PUBLIC UTILITIES COMMISSION  
EXECUTIVE DIVISION  
ROOM 5205  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[u06@cpuc.ca.gov](mailto:u06@cpuc.ca.gov)

GLEN WALKER  
CALIF PUBLIC UTILITIES COMMISSION  
DIVISION OF ADMINISTRATIVE LAW JUDGES  
ROOM 5106  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[gew@cpuc.ca.gov](mailto:gew@cpuc.ca.gov)

JOY MORGENSTERN  
CALIF PUBLIC UTILITIES COMMISSION  
MARKET STRUCTURE BRANCH  
AREA 3-D  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[jym@cpuc.ca.gov](mailto:jym@cpuc.ca.gov)

KARL BEMESDERFER  
CALIF PUBLIC UTILITIES COMMISSION  
EXECUTIVE DIVISION  
ROOM 5304  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[kjb@cpuc.ca.gov](mailto:kjb@cpuc.ca.gov)

KATHERINE S MOREHOUSE  
CALIF PUBLIC UTILITIES COMMISSION  
CARRIER BRANCH  
AREA 3-E  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[ksm@cpuc.ca.gov](mailto:ksm@cpuc.ca.gov)

MARY EVANS  
CALIF PUBLIC UTILITIES COMMISSION  
PUBLIC ADVISOR OFFICE  
AREA 2-F  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[mle@cpuc.ca.gov](mailto:mle@cpuc.ca.gov)

PETER HANSON  
CALIF PUBLIC UTILITIES COMMISSION  
EXECUTIVE DIVISION  
ROOM 4104  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[pgh@cpuc.ca.gov](mailto:pgh@cpuc.ca.gov)

PHILIP S. WEISMEHL  
CALIF PUBLIC UTILITIES COMMISSION  
DIVISION OF ADMINISTRATIVE LAW JUDGES  
ROOM 5114  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[psw@cpuc.ca.gov](mailto:psw@cpuc.ca.gov)

PHYLLIS R. WHITE  
CALIF PUBLIC UTILITIES COMMISSION  
MARKET STRUCTURE BRANCH  
AREA 3-D  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[prw@cpuc.ca.gov](mailto:prw@cpuc.ca.gov)

SIMIN LITKOUHI  
CALIF PUBLIC UTILITIES COMMISSION  
TELECOMMUNICATIONS & CONSUMER  
ISSUES BRA  
ROOM 4101  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[sim@cpuc.ca.gov](mailto:sim@cpuc.ca.gov)

TIMOTHY J. SULLIVAN  
CALIF PUBLIC UTILITIES COMMISSION  
EXECUTIVE DIVISION  
ROOM 5204  
505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3214

[tjs@cpuc.ca.gov](mailto:tjs@cpuc.ca.gov)