Decision **PROPOSED DECISION OF ALJ PULSIFER** (Mailed 10/19/2005)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Joint Application of SBC Communications Inc. ("SBC") and AT&T Corp. ("AT&T") for Authorization to Transfer Control of AT&T Communications of California (U-5002), TCG Los Angeles, Inc. (U-5462), TCG San Diego (U-5389), and TCG San Francisco (U-5454) to SBC, Which Will Occur Indirectly as a Result of AT&T's Merger With a Wholly-Owned Subsidiary of SBC, Tau Merger Sub Corporation.	Application 05-02-027 (Filed February 28, 2005)

(See Appendix A for List of Appearances.)

OPINION APPROVING APPLICATION TO TRANSFER CONTROL

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OPINION APPROVING APPLICATION TO TRANSFER CONTROL

I. Introduction

A. Summary

We hereby approve the application of SBC Communications, Inc. (SBC) and AT&T Corp. (AT&T) (collectively, Applicants) for authority to transfer control of AT&T Communications of California and its related California affiliates subject to the terms and requirements set forth in this order. We have reviewed the proposed merger under the authority of Pub. Util. Code § 854 to determine whether it is in the public interest. We have determined that all of the provisions of § 854 apply to this transaction.

The Applicants must meet the conditions adopted herein in order to provide reasonable assurance that the proposed transaction will be in the public interest in accordance with Pub. Util. Code § 854. The conditions adopted herein are based upon review of the proposals submitted by parties in this proceeding. Although we do not discuss every single proposal that was presented, we have taken parties' proposals into consideration in developing the adopted conditions. We only adopt conditions which mitigate an effect of the merger in order to satisfy the public interest requirements of § 854. The fact that we decline to adopt a particular party's proposed condition should not be construed as an indication of whether or not the proposal may have merit in some other context or proceeding. We find that, subject to Applicants' compliance with the adopted conditions, the merger will produce net benefits for consumers and will not adversely affect competition for telecommunications service in California. Conversely, if the Applicants declined to implement the conditions set forth herein, we would conclude that the merger did not comply with § 854 and could not be approved.

B. Background

On February 28, 2005, SBC Communications, Inc. and AT&T Corp. filed a joint application for authorization to transfer control of AT&T Communications of California, TCG Los Angeles, Inc. TCG San Diego, and TCG San Francisco from subsidiaries of AT&T to subsidiaries of the combined organization that will result from AT&T's planned merger with SBC.[1] The proposed merger would create the largest telecommunications firm in the United States.

Under the proposal, AT&T would merge into a newly formed wholly-owned subsidiary of SBC, created for the specific purpose of this transaction. AT&T will be the surviving entity of the merger for legal purposes. AT&T shareholders will receive 0.77942 shares of SBC stock for each share of AT&T stock they own, as well as a one-time cash dividend from AT&T of $1.30 per AT&T share. SBC shareholders will continue to own SBC stock and otherwise will not be affected by the transaction. Upon completion of the merger, former AT&T shareholders will hold approximately 16% of SBC's outstanding shares.

The application, as originally filed on February 28, 2005, requested Commission authorization of the transaction pursuant to Pub. Util. Code § 854(a) on an expedited basis with no evidentiary hearings. Applicants did not initially include a showing under Section 854(b) of the Public Utilities Code, instead claiming that the transaction is exempt from § 854(b).[2] Additionally, although

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[1] Unless otherwise noted, subsequent references herein to AT&T California include, by reference these TCG affiliates.

[2] Section 854(b) requires the Commission to find that the proposed change in control provides short-and long-term benefits to customers (§ 854(b)(1), equitably allocate

Footnote continued on next page

Applicants also believe that § 854(c)[3] should not apply, they supplied information in the application that they asserted met the § 854(c) criteria for approval.

On March 16, 2005, an Assigned Commissioner's Ruling required supplementation of the application to provide information necessary to comply with all Pub. Util. Code §§ 854(b) and (c) requirements. Although the Assigned Commissioner deferred ruling on the applicability of § 854(b) and (c), he required the supplemental filing in the interest of ensuring that any potential disagreement over the statute's applicability not be a cause for delay in adjudicating the application.

On March 30, 2005, the Applicants filed a "Joint Supplemental Application of SBC Communications, Inc. and AT&T Corp." in response to the Assigned Commissioner's Ruling, dated March 16, 2005. Protests to the Application were filed on April 14, 2005, by the following parties: California Association of Competitive Telephone Companies (CALTEL);[4] the Communications Workers of America (CWA)[5], AFL-CIO; the Community Technology Foundation of California; Eschelon Telecom, Inc. and Advanced TelCom, Inc.; Level 3 Communications, LLC; Navigator Telecommunications, LLC; the Office of

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forecasted short-and long-term economic benefits where the Commission has ratemaking authority (§ 854(b)(2), and determine that the change in control does not adversely affect competition (§ 854(b)(3)).

[3] Section 854(c) requires the Commission to apply eight criteria in its evaluation of whether a transaction is in the public interest.

[4] CALTEL filed its protest on behalf of its member companies.

[5] CWA formally withdrew its protest on June 14, 2005.

Ratepayer Advocates (ORA) and the National Consumer Law Center; Pac-West Telecomm, Inc.; Qwest Communications Corporation (Qwest); the City and County of San Francisco; Telscape Communications, Inc.; The Utility Reform Network (TURN), Utility Consumers' Action Network, Disability Rights Advocates (DRA), Consumers Union of U.S., Inc., the Greenlining Institute (Greenlining) and the Latino Issues Forum (LIF); US LEC; WilTel Communications, Inc.; and XO Communications Services, Inc.[6]

Intervenors claim that the merger, in the form proposed by Applicants, will not assure net benefits to consumers and will adversely affect competition for telecommunications services in California. Certain intervenors categorically oppose the merger under any conditions, claiming that even with certain mitigating conditions, the merger will still be anticompetitive. They argue that SBC already has a dominant share of the market, and that acquisition of AT&T will only further expand its market power by eliminating its largest competitor. Other intervenors do not oppose the merger, as long as certain conditions are adopted to mitigate perceived adverse impacts. Certain parties express concern that the interests of various underserved communities have not been properly addressed. Parties also argue that the proposed Verizon and MCI merger must be also taken into account, as well, in light of its cumulative effect on reducing competition.

Joint Applicants filed a reply in opposition to the protests on March 30, 2005, asserting that the merger is in the public interest, and that there are no

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[6] The following parties subsequently withdrew their protests as follows: WilTel on June 18, 2005; US LEC on June 21, 2005; Eschelon Telecom and Advanced TelCom on June 24, 2005; and XO on June 24, 2005.

adverse competitive effects. A prehearing conference was held on April 20, 2005, and the Assigned Commissioner issued a Scoping Memo by Ruling on April 26, 2005, directing that evidentiary hearings would be held. Applicants served opening testimony on May 6, 2005, and intervenors served reply testimony on June 24, 2005. Applicants served rebuttal testimony on July 8, 2005. Twenty-eight witnesses submitted testimony. ORA and TURN presented 11 witnesses. Seven witnesses were presented by parties representing competitors including CALTEL, Cox, Qwest, Level 3, Telscape, and Pac-West. Other parties presenting witnesses were Latino Issues Forum(LIF); Community Technology Federation of California (CTFC); Disability Rights Advocates (DRA), The Greenlining Institute (Greenlining); and City and County of San Francisco.

Evidentiary hearings were held from August 8-12 and 15-17. Opening briefs were filed on September 9 and reply briefs were filed on September 19, 2005. Concurrently with their opening briefs, a proposed settlement on certain issues was filed and served, jointly sponsored by Applicants Greenlining, and LIF.

A series of Public Participation Hearings (PPHs) were also conducted in locations throughout the state. The Commission held these hearings in Oakland, Sacramento, Fresno, Culver City, Anaheim, Riverside, and San Diego. These hearings were well attended, particularly in Oakland and Culver City. Many representatives from community organizations and some individuals attended the hearings, presenting a variety of views concerning the proposed merger. Both during and subsequent to the PPHs, many additional individuals and representatives of community organizations contacted the Commission with written letters and by electronic mail expressing their views on the proposed merger. We have reviewed and taken into account, as appropriate, the comments presented by members of the public, both at the PPH and through subsequent cards, letters, and electronic mailings to the Commission. We wish to express our appreciation to all of the individuals who took the time to attend the PPHs or to otherwise communicate their comments.

C. Reasons for the Proposed Merger and Acquisition

This Application seeks approval of the California portion of a larger national and international merger. This merger comes at a time when the entire telecommunications industry is facing major competitive challenges and new technological options.

For generations up until 1984, telecommunications services had been provided nationally by monopolies subject to traditional state and federal price regulation. This arrangement ended in 1984 with the divestiture of American Telephone and Telegraph Company (also known as the "Bell System") through an antitrust consent decree between the United States Department of Justice (DOJ) and AT&T. The consent decree divested AT&T of its local telephone operations from which several independent "Regional Bell Operating Companies" (RBOCs) were created. The 1984 divestiture was required to address various ways in which the former Bell System impeded competition, particularly through its exercise of bottleneck monopoly control over the critical "last mile" linking individual customer premises to the public switched network.

Concurrent with the divestiture, state and federal regulators began initiatives to open the telecommunications marketplace to competition. Competitive barriers to entry were first lifted in the long distance market for carriers other than the incumbent local exchange carriers. With the passage of the 1996 Telecommunications Act, further progress was made toward opening local exchange markets to competition. More recently the long distance market has been opened to the Incumbent Local Exchange Carriers (ILEC).

Concurrently with opening of more markets to competition, there has been continuing evolution in the industry structure, including the introduction of new technologies to compete with the traditional telephone service. In response to these regulatory, technological, and economic challenges, various carriers, including the traditional RBOCs, have progressively consolidated their operations through mergers and acquisitions in recent years.

The proposed SBC/AT&T merger marks a significant crossroads in the trend toward consolidation within the industry. Some parties have characterized this merger as the recombining of the Bell System, albeit without the regulatory controls that formerly existed. We fully recognize, however, that the regulatory, economic, and technological climate in which this merger arises is very different from that of the 1984 divestiture. Although AT&T remains the largest competitor of SBC in California, the AT&T of today is different in many respects from the company that was divested 21 years ago. Nonetheless, fundamental concerns over this transaction's effects on competition and the public interest remain equally paramount today. Accordingly, given the far-reaching scope and implications of this merger for the industry and the public interest, we approach our review of this merger with great care.

SBC's stated purpose in the acquisition of AT&T is to combine the complimentary strengths of the two companies to enable the merged company to compete more effectively in the telecommunications marketplace. The SBC network is nearly ubiquitous where it is the incumbent but virtually nonexistent outside of its ILEC footprint. On the other hand, AT&T's network was initially constructed as a long distance network, and not limited by a need to serve any end points in a local service area. In contrast to SBC's largely local and regional presence, AT&T operates in more than 50 countries, serving the largest global enterprises with a broad array of voice, data and IP-based services. AT&T focuses on enterprise business and government customers through its national and global network.

By combining their respective strengths, Applicants claim that the merger will enable the combined company to become a stronger competitor, and to serve a wider range of customers across all segments of the telecommunications marketplace beyond just the traditional SBC California territory.

AT&T likewise views the merger as an appropriate response to developments that have challenged its competitive stance in certain markets. Among the most significant changes in this regard has been SBC California's entry into the long-distance market. Once SBC California entered the long distance market, it could successfully bundle long distance with local service offerings. SBC thereby strengthened its competitive position compared with that of AT&T. Since receiving authority to offer long distance service, SBC has accumulated in-region market share faster than any other non-ILEC competitor.[7] AT&T has been less successful in being able to offer bundled service without the vast local exchange network that its competitor, SBC, possesses. To a great extent, AT&T had relied on the unbundled network element platform (UNE-P) in providing mass market local exchange service and the purchase of special access for other applications. With the elimination of UNE-P as a competitive resource, AT&T stopped marketing local service to new mass market customers. AT&T

[7] Ex.109, Sumpter Testimony (Pac-West) at 11-12.

chose to consider new options, leading ultimately to the merger that is the subject of the application before us.

II. Standard for Review

The Applicants must obtain authorization from this Commission for approval of the proposed acquisition of AT&T by SBC in accordance with the requirements of Pub. Util. Code § 854 which sets forth the standard for review of the transaction. While all parties agree on the general statutory applicability of § 854, there is significant disagreement as to which subsections of the statute apply, and how extensive the scope of review should be. Section 854(a) provides that no person or corporation shall merge, acquire, or control either directly or indirectly, any public utility organized and doing business in this state without first obtaining authorization from this Commission. Any merger, acquisition, or transfer of control without prior Commission authorization is void and of no effect. As discussed below, we conclude that the standard of review in this Application must take into account all provisions of § 854.

In weighing the evidence before us, we note that Applicants bear the burden of proof. Applicants were required to prove by a preponderance of the evidence that the proposed merger meets the requirements warranting approval pursuant to § 854(e). Preponderance of the evidence:

> “means that evidence in support of Applicants' position, when weighed with that opposed to it, must have the more convincing force and the greater probability of truth. (1 Witkin, California Evidence (3d. Ed. 1986) § 157, and cases cited thereunder.)
>
> “Black's Law Dictionary defines 'preponderance' as 'greater weight of evidence, or evidence which is more credible and convincing to the mind[;t]hat which best accords with reason

> and probability.'" (Decision (D.) 91-05-028, 40 CPUC2d 159, 172.)

In particular, we must find the proposed merger provides short-term and long-term economic benefits to ratepayers, does not adversely affect competition, and is in the public interest. (§§ 854(b) and (c).) To the extent that we find Applicants have not met their burden of proof, we consider the countervailing evidence of opposing parties concerning mitigating measures that are warranted in order for the merger to meet § 854 requirements in the public interest. Accordingly, the findings that we make concerning the proposed transaction apply this evidentiary standard in fashioning conditions on our approval.

A. Applicability of Section 854(b) and (c)

1. Significance of Defining the Transaction as a Holding Company Transfer

a) Parties' Positions

Applicants acknowledge that the Commission has authority over approval of the transaction pursuant to § 854(a), but deny that § 854 (b) applies. Applicants argue that § 854 (b) only applies to "transactions in which a regulated utility is a direct party." (Application, at p. 17.) This transaction, however, is designed as a merger only between corporate holding companies. Because the merger agreement does not technically define any California utility entity as a party, Applicants claim that § 854(b) does not apply. Pub. Util. Code, § 854(b) specifically requires, as a condition for Commission approval, that a transaction:

1. Provides short-term and long-term economic 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.[8]

Sections 854(b) applies where any utility that is a party to the transaction has gross annual California revenues exceeding $500 million. In this instance, even though SBC California and AT&T California each have gross annual California revenues exceeding $500 million, the Applicants argue that this proposed transaction does not come under the provisions of § 854(b).

In support of the claim that § 854(b) does not apply, Applicants note that the term “utilities” referenced in § 854 (b) differs from the term “entities” that is used in § 854 (c).[9] Section 854(c) states that it applies to any entity that is a party to the transaction with gross annual California revenues exceeding $500 million, and requires the Commission to consider each of the criteria listed in that subsection, and to find, on balance, that the proposal is in the public interest.

Applicants construe the use of different terms (i.e.,“utility” in § 854(b) versus “entity” in § 854(c)) as an intentional distinction made by the Legislature to indicate different categories of applicability. Applicants thus infer that § 854(b) only applies to a narrower category of transactions in which a utility is

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[8] 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.

[9] The requirements of § 854(c) apply to any *entity* that is a party to the transaction with gross annual California revenues exceeding $500 million, and require the Commission to consider each of the criteria listed in paragraphs (1) through (8) of that subsection, and to find, on balance, that the proposal is in the public interest..

named as a direct party to the transaction. Since Applicants have defined the parties to this merger as parent-level holding companies only, they claim it is not subject to § 854(b).

By contrast, Applicants construe § 854(c) as applying to a "broader category of transactions." Yet, even though Applicants acknowledge that § 854(c) technically applies here, they likewise argue that the Commission has discretion to exempt this transaction from the requirements of that subsection. Nonetheless, Applicants claim that this transaction satisfies § 854(c) requirements. Mergers subject to § 854(c) require as a basis for approval, findings that the merger is in the public interest by considering the following criteria:

> (1) The financial condition of the resulting public utility doing business in the state.
>
> (2) The quality of service of the resulting public utility doing business in the state.
>
> (3) The quality of management of the resulting public doing business in the state.
>
> (4) Fairness to affected public utility employees.
>
> (5) Fairness to the majority of all affected public utility shareholders.
>
> (6) Benefits on an overall basis to state and local economies, and to be communities in the area served by the resulting public utility.
>
> (7) The preservation of jurisdiction of the commission and the capacity of the commission to effectively regulate and audit public utility operations in the state.
>
> (8) Mitigation measures to prevent significant adverse consequences which may result.

All active parties in the proceeding other than Applicants take the position that both § 854(b) and (c) apply to this transaction, and that the Commission must make findings consistent with those code sections in order to warrant approval of this merger. They argue that Applicants' legal interpretation seeking to limit the applicability of the statute here is invalid and fails to acknowledge the importance of this transaction. Parties also challenge Applicants' attempts to justify a § 854(b) and (c) exemption based upon comparison with other merger cases, claiming that such cases did not involve a dominant carrier and are not comparable to this proceeding.

b) Discussion

We conclude that §§ 854(b) and (c) apply to this transaction. Sections 854(b) and (c) is "the primary statute governing mergers involving California's large energy and telecommunication utilities."[10] This transaction involves both the largest ILEC and the largest Competitive Local Exchange Carrier (CLEC)/NonDominant Interexchange Carrier (NDIEC) in California. The two major transactions creating what is now Verizon were also reviewed under §§ 854 (b) and (c).[11] Likewise, SBC's acquisition of Pacific Telesis was reviewed under §§ 854(b) and (c).

We reject Applicants' argument that special significance attaches to the use of the words "utilities" versus "entities" in assessing the applicability of §§ 854(b)

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[10] *SCEcorp,*, 40 Cal. P.U. 2d at p. 171.

[11] In *GTE Corporation* (1991) 39 Cal. P.U.C.2d 480 (D. 91-03-022), the Commission reviewed the GTE/Contel merger under Section 854 (b) and (c). (Id., at p. 484.) Also, in *GTE and Bell Atlantic* (2000) 2000 Cal. PUC LEXIS 398 (D.00-03-021), the Commission reviewed the merger leading to the formation of Verizon under §§ 854 (b) and (c).

and (c).[12] In the SBC/Telesis merger proceeding, we similarly rejected this line of argument that § 854(b) does not apply merely because the transaction was defined as a transfer of control between holding companies as "parties." As explained in D.97-03-067, the word "party," as used in § 854(b), must be read to include those California entities that are "involve[d]" in the transaction even if the deal is "technically structured" so only the parent-level companies participate in the merger transaction.[13] Even though the SBC/Telesis merger nominally involved two holding companies, we still held that the California operating company, "Pacific[,] is a party within the meaning of § 854." (*Ibid.*) We avoided basing our decision on a mere technical interpretation of the words "utility" and "entity" because such an approach looked too much to the mere form of the statute and the transaction. (Id. at p. 364).[14]

The SBC/Telesis decision followed California Supreme Court precedent that a utility cannot "through corporate instrumentalities obtain" a result that is different from the result "the utility would be entitled to absent the separate corporate enterprises." (Pacific Telesis Group, supra, 71 Cal. P.U.C.2d at p. 365.) Despite Applicants' claims, the substance of the transaction is not changed merely because a holding company structure is formed around a regulated utility.

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[12] *Pacific Telesis Group* (1997) 71 Cal. P.U.C.2d 351 (D.97-03-067).

[13] *Id*, at p. 365.

[14] The fact that the Commission focused on the regulatory status of the acquired company, Pacific Telesis is explained by the fact that the acquiring company, SBC, had <u>no</u> presence in California. Here both the acquired company <u>and</u> the acquiring company have major California operations.

It would be equally improper to elevate form over substance here by exempting the SBC / AT&T transaction from § 854 (b) review. Even though the transaction is defined as involving only holding companies as “parties,” the substance of the transaction will have a significant impact on California public utilities and their customers. The Commission has broad statutory powers to assure that ratepayers are not deprived of the benefit of transactions where the utility would have been directly involved, but for the holding company structure. We view the utility enterprise as a whole without regard to the separate corporate entities which in effect are different departments of one business enterprise (General Telephone Company v. Public Utilities Commission (1983) 34 Cal.3d 817, 826).

Designing the transaction around of a holding company structure provides no reason to reduce the review that the Commission gives to this transaction. Ratepayers can be exposed to even more risk under a holding company structure, as we have previously noted:

> The regulator has no choice but to view costs assigned to utility subsidiaries by holding companies very skeptically, especially where the corporate family is in diversified lines of business, because there is always the motive and temptation to have as many costs as possible born by the utility’s monopoly operation.

(Re Pacific Bell (1986) 20 CPUC 2d 237, 274-275; D.86-01-026.)

We likewise reject Applicants’ argument that the reasoning applied in the SBC / Telesis merger concerning the applicability of §§ 854(b) and (c) does not apply to this transaction because the firm being acquired here is not a dominant carrier. We recognize that the SBC / Telesis merger involved the acquisition of an ILEC, while this merger does not. The fact remains that this transaction involves an acquisition by SBC that will have an impact on the operations of SBC California, as well as the competitive environment in which the ILEC operates.

Applicants are incorrect to claim that the Commission does not look to the status of an acquiring firm in assessing the applicability of § 854(b). One of the main considerations in MCI Communications Corp. (MCI) and British Telecom (BT) (1997) 72 Cal.P.U.C.2d 656 (D.97-05-092) was the nature of the acquiring firm's business. The Commission relied heavily on the fact that BT, the acquiring firm, "operates exclusively in the United Kingdom and does not propose physically to enter California markets."[15] In addition, the analysis called for in § 854(b) looks to the combined effect of the transaction participants. Transaction benefits are often derived from the combination of two firms. Anti-competitive effects also arise from the combination of two firms. Accordingly, we reject Applicants' argument that the Commission should only focus on the acquired firm.[16]

Thus, the common element in both the Telesis merger and this transaction is a business combination in which the operations of the largest California ILEC are implicated. While the specific form of business combination is different, the principle remains relevant that form should not be placed over substance in assessing the applicability of §§ 854(b) or (c).

Even though Applicants claim that the SBC California local network is not impacted, their testimony nonetheless indicates that customers of the ILEC will be impacted by the merger. For example, Applicants claim that AT&T services

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[15] *MCI Communications Corp. and British Telecom* (1997) 72 Cal.P.U.C.2d. 656, 664.

[16] Joint Applicants' Opening Brief, at p. 34.

will be delivered to SBC customers (e.g., CallVantage), or use AT&T facilities to deliver services (e.g., AT&T Internet backbone).[17] SBC's role in the enterprise market is emphasized by Applicants as a primary motivation for entering into the merger. Applicants acknowledged that some of the services provided to enterprise customers in California will be subject to the Commission's ratemaking authority.[18] Applicants claim that the combined company will have enhanced resources, expertise and incentive to adapt the sophisticated products that AT&T has developed for its enterprise customers to the needs of SBC California's small and medium businesses and consumers.

Both the SBC/Telesis merger and this transaction likewise involve significant changes to the competitive environment within California that warrant review under §§ 854(b) and (c). Moreover, in the SBC/Telesis merger, the two merging parties did not compete against each other within California. By contrast, both SBC and AT&T compete against each other within California. Thus, the competitive significance of two major competitors merging should be reviewed at least as carefully as the SBC/Telesis merger where only one California competitor was involved.

While AT&T's California operations relative to the total merged firm may be viewed as "small," AT&T California operations are still significant in relation to competitors in California. SBC California and AT&T California each have intrastate revenues exceeding $500 million per year which is the threshold level

[17] Ex. 43, at p. 119, SBC/Kahan, Ex. 33, at p. 5 SBC/Rice.

[18] Tr., vol. 11, at p. 1571, SBC/Kahan.

to trigger the requirements both of §§ 854(b) and (c). Thus, AT&T California operations meet the materiality threshold under § 854(b).

2. Discretion to Grant Exemptions Under Section 853(b)

a) Parties' Positions

Applicants argue that even if the Commission were to determine that § 854(b) may technically be applied here, it is within the Commission's discretion to grant an exemption. In addition, while Applicants apparently concede that § 854 (c) technically applies to this transaction, they argue that the Commission should exempt it from § 854(c) review, as well. Section 854(c) sets forth a set of public interest criteria to be met in order for approval of a merger subject to its provisions, as previously enumerated above.

Applicants argue that the Commission has such discretion to grant an exemption pursuant to § 853 (b) which provides in relevant part:

> The commission may. . . exempt any public utility. . . from this article [including Sections 854(b) and (c)] if it finds that the application thereof with respect to the public utility . . . is not necessary in the public interest."

The Applicants thus argue that the Commission should exercise its discretion under § 853 (b) to exempt this transaction from review under both §§ 854(b) and (c), and instead merely apply the less rigorous standard of § 854(a).

Opposing parties disagree, arguing that to exempt this application from review based upon § 853(b) would not be in the public interest. Parties argue that, in view of the record on the impacts of this merger, there is no factual basis for a finding that applying §§ 854(b) and (c) is "not necessary in the public interest."

Applicants argue, however, that exempting this transaction from §§ 854(b) and (c) is warranted because the Commission has previously exempted other merger transactions involving NDIEC and CLEC assets that have come before the Commission. Applicants compare this merger as being similar to previous mergers involving the acquisition of a nondominant carrier. Opposing parties disagree, arguing that such a characterization overlooks the major competitive significance of this merger, and ignores critical differences that distinguish this merger from others in which § 854(b) and (c) exemptions were granted. Opposing parties note that in past merger cases where §§ 854(b) and (c) were not applied, the transaction exclusively involved NDIEC and CLEC assets where the surviving utility was nondominant. By contrast, this merger also involves the assets and operations of the largest ILEC in California. Parties thus argue, given the involvement of ILEC operations, the need for the safeguards provided by §§ 854(b) and (c) figures more significantly here.

b) Discussion

Given its distinctive historic proportions and long-term implications for competition, we conclude that this merger is not analogous to previous mergers that were routine in nature, and that exclusively involved NDIEC and CLEC assets. The exemptions granted in those past mergers thus provide no comparable basis for §§ 854 (b) and (c) exemptions here.

This merger also has greater long term implications compared with other nondominant carrier mergers in view of the concurrent merger contemplated between Verizon and MCI. The post-merger environment thus anticipates elimination of not just one, but both of the two largest competitors of SBC in California. None of the merger precedents cited by Applicants contemplated such a fundamental and historic shift in the competitive make-up of the industry.

Concerns over the potential to exercise market power to the detriment of competition are more heightened here where the ILEC's largest competitor will subsequently be controlled by SBC.

For similar reasons, Applicants argument is unpersuasive that the §§ 854(b) and (c) exemption applied in the MCI/BT merger have relevance here. In that proceeding, MCI/BT claimed that §§ 854 (b) and (c) should not apply "when no regulated monopolist or dominant carrier is involved in a merger…" (72 CPUC2d 656, 660, D.97-05-092). Unlike the MCI/BT proceeding, a dominant carrier is involved in this transaction.

Past telecommunications transactions involving utilities exempted from review by virtue of § 853(b) presented factors that are not present here. They did not involve an ILEC, they often did not involve more than one California operating utility. For example, the proposed BT/MCI transaction was a foreign takeover where MCI would have become the U.S. operating arm of BT. The WorldCom case was a bankruptcy reorganization where MCI succeeded to the business of the discredited WorldCom. The fact that the Commission sometimes exempts transactions involving a "pure" change of control—and no operational integration—does not establish any authority supporting an exemption here.

In the Decision involving the incomplete MCI/Sprint merger, we also refused to apply an exemption, and required §§ 854 (b) and (c) review. (MCI WorldCom and Sprint (2001) 2001 Cal. PUC LEXIS 142 (D.01-02-040).)

On the other hand, the fact that the SBC/Telesis and the GTE/Bell Atlantic merger transactions did receive scrutiny under § 854(b) and (c) shows that even "pure" change of control transactions merit review under §§ 854(b) and (c). In Pacific Enterprises (1998) 79 Cal. P.U. 2d 343 (D. 98-03-073), and SCEcorp, the Commission also applied §§ 854(b) and (c) without extensive consideration of exemptions or other legal theories. Accordingly, we find that past precedent supports the application of §§ 854(b) and (c) to the proposed SBC / AT&T merger.

III. Net Benefits Showing Pursuant to Section 854(b)(2)

Section §854 (b)(2) requires that, in order to warrant approval, merger transactions must produce both "short-term" and "long-term" economic benefits. In addition, § 854(b)(2) requires the Commission to:

> Equitably allocate, 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.

Section 854(b)(2) thus requires that ratepayers receive at least 50% of the economic benefits of the merger attributable to California measured over the "short term" and "long term," and that the Commission has discretion to allocate the remaining 50% between ratepayers and utility shareholders as specific circumstances warrant. To the extent that specific applicable savings from the merger can be identified, we find that a 50% sharing of those savings between ratepayers and investors is reasonable and consistent with requirements of § 854(b)(2).

A. Qualitative Benefits In Relation to Section 854(b) Requirements

1. Parties' Positions

Applicants' primary claim is that there are no savings from the merger specifically attributable to serving California retail customers, and that there should be no mandatory surcredits or other pass-through of savings to retail customers as a condition of approving the merger. Applicants claim that, to the extent that California retail customers realize any benefits from the merger, such benefits will be in the form of improvements in the range and quality of service, as a result of combining the strengths of SBC and AT&T.

Applicants claim that the merger will facilitate a unified "end-to-end" IP network for ordering, provisioning and maintaining voice, data, and video services. A single, unified IP network will enhance the ability to share bandwidth, and to offer better bandwidth-intensive services. The combined network can also exploit superior speech/text technologies to provide more robust fraud and network security, and to provide superior provisioning and repair.

ORA argues that Applicants' claims of mere qualitative, or "soft," benefits are not the "economic benefits" required by § 854(b). ORA witness Selwyn testified that service quality improvements would not "constitute an 'economic benefit' for California ratepayers" unless "existing service quality [from Applicants]. . . in California today is less than satisfactory." (Ex. 126C, p. 18, ORA/Selwyn.) Applicants have not contended that existing service quality is unsatisfactory, nor have they provided specific details about how the merger would improve service quality in California. Applicants make no attempt to associate specific, tangible economic benefits with their claim that the merger will increase innovation.[19] Thus, ORA argues that Applicants' claimed benefits

[19] ORA witness Selwyn pointed out that the existence of risks diminishes the potential value of a particular outcome. Any attempt to quantify the effects of soft benefits, must take into account both the likelihood of the benefit not occurring and the likelihood of a risk offsetting the benefit. (Ex. 126C, pp. 42-43, ORA/Selwyn.)

are not designed to improve any current deficiencies in either SBC's or AT&T's services.

2. Discussion

We agree that "soft" benefits, as described by Applicants, do not satisfy the net benefits requirements of § 854(b). Most of Applicants' highlighted advantages of the merger, such as network integration, and the ability to attract a larger number of large global customers, are essentially shareholder benefits. (E.g., Tr. Vol. 10, p. 1379 SBC/Rice. Such "soft" benefits would impact consumers only to the extent they manage to "find [their] way into consumer" segments of the market via a "ripple down" effect. (Tr., vol. 9. p. 1279 AT&T/Polumbo.)

Applicants' witnesses are vague about whether, or when, any consumer benefits at all might be realized. Witness Polumbo stated, "there is no mention of timing." (Tr., vol. 9. p. 1278, AT&T/Polumbo.) With regard to network benefits, SBC witness Rice disagreed with the claim that voice services would be improved by interconnecting the two applicant's networks. (Tr., vol. 10. p. 1401 SBC/Rice.) He stated that the Applicants' "intention" was to develop new products and "apply them to the enterprise market, but we think many of them will apply to the mass market as well." (Tr., vol. 10. p. 1534 SBC/Rice.) Asked about next-generation applications he testified: "We don't know specifically what they are going to be." (Tr., vol. 10. p. 1535 SBC/Rice.) Rice further testified about "interesting projects" but could not specify pricing information because "we don't know the details." (Tr., vol. 10. p. 1536 SBC/Rice.)

ORA witness Selwyn challenges Applicants claims of innovation from the merger, arguing that competition, not the scale of operations, is the driver of innovation. Dr. Selwyn pointed out that firms with few or no rivals have little incentive to bring new products to market. (Ex. 126C, p. 26, ORA / Selwyn.) Academic literature also corroborates that competition drives innovation.[20]

On the other hand, the proposed merger is risky for ratepayers. ORA witness Selwyn testified that the merger could lead to an overall increase in the rates consumers pay for services subject to the Commission's ratemaking authority, even if in the aggregate, the merger produces positive economic benefits to Joint Applicants.

We next proceed to determine if there are quantitative net benefits to ratepayers due to the merger, and the extent to which consumers receive a share of any such benefits as required under § 854(b).

B. Applicants' Calculations of Section 854(b) Savings From the Merger

Regarding the quantification of net customer benefits expected from the merger, Applicants sponsored the testimony of James Kahan, SBC Senior Executive Vice President of Corporate Development. Mr. Kahan is responsible for the analysis and negotiation of mergers and acquisitions for SBC. The financial projections supporting the analysis of this transaction were created by Mr. Kahan's staff at his direction.

Although Applicants dispute that § 854 (b) applies to the SBC / AT&T acquisition, in compliance with the previously-referenced Assigned Commissioner's Ruling, they produced a calculation of certain merger-related savings that could theoretically be shared with California customers. These

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[20]. *See, e.g.,* Wendy Carlin, *et al., A Minimum of Rivalry: Evidence from Transition Economies on the Importance of Competition for Innovation and Growth,* Contributions to Economic Analysis & Policy, Vol. 3, Number 1, 2004, Article 17, cited in Ex. 126C, ORA / Selwyn.

savings are generally referred to as "synergies." To calculate a California share of merger savings, Applicants start with the base figure for merger-related savings derived from SBC's "National Synergy Model".

The National Synergy Model was created during the "due diligence" process prior to SBC's signing of the Merger Agreement with AT&T to assist senior management and the board of directors in evaluating the transaction, and to assist in determining the price to pay for AT&T. All expected synergies, or savings, from the merger on a global basis are addressed in the National Synergy Model.

The National Synergy Model identifies approximately $16 billion (net present value) in synergies from the proposed merger on a global basis. The Applicants attribute almost 50 percent of these synergies to network operations and IT functions, with substantial synergies from procurement cost savings and increased revenue opportunities.[21] Applicants also expect synergies from the reduction in third party network expenses due to moving network traffic onto AT&T's network, elimination of overlap between SBC and AT&T's staff relating to national networks, enterprise sales and support, and headquarter operations (e.g., finance, accounting, human resources, and legal).

Although Applicants expect $16 billion in benefits, they deny any meaningful synergies will be achieved in local network operations or personnel, claiming that AT&T has few, if any, local network facilities. In evaluating the merger, the Applicants did not analyze California-specific quantifiable benefits, but only considered benefits at a national level. AT&T predominantly provides

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21 SBC Press Release, January 31, 2005.

mass market service via the Unbundled Network Element Platform (UNE-P) relying on the network of SBC and others to provide local retail service. These UNE-P customers are already being served over the existing SBC local network and this arrangement is not expected to change after the merger. Applicants' witness Rice testified that there will be no changes in SBC California's local network as a result of the network integration that is contemplated post-merger.

Notwithstanding its claim that there are no significant synergies related to California retail services, Applicants performed a calculation of net customer benefits in response to the Assigned Commissioner's Ruling. Applicants calculated operating synergies in California relating to: (1) total revenues and operating expenses in 2004 for both SBC and AT&T; (2) California intrastate total revenue and operating expenses for AT&T's California certificated subsidiaries in 2004; and (3) the combined company operating expense synergy forecasts presented by senior management to the board of SBC.

By taking AT&T's estimated operating expense for California as a percentage of the combined firm operating expense, the Applicants estimated a California operating expense factor. This factor was multiplied by the forecasted net expense synergies for the combined company for each of the first five years post-closing, yielding estimated California-specific expense synergies for each year.

The Applicants then discounted the forecasted synergies to present value to compute economic benefits to be $27 million attributable to AT&T California local and intrastate operations. Applicants then reduce the $27 million savings by 50% (based on the § 854(b) directive) to assign approximately $14 million as the savings available to California consumers.[22] This amount represents only 2/10 of 1% of the total corporate synergies.

C. ORA and TURN Calculations of Section 854(b) Savings Attributable to California

ORA and TURN each performed their own analysis of synergy savings attributable to California consumers, and presented testimony concluding that Applicants' calculation of the total merger synergies allocated to California consumers was significantly understated. As a basis for their calculations, ORA and TURN relied on the Applicants' synergy model as a starting point, and made adjustments to the Applicants' figures. On a net present value basis, taking into account adjustments for the alleged deficiencies, ORA estimates of the correct amount of synergies attributable to California is $1.84 billion, while TURN calculates the amount as $1.983 billion.[23] ORA and TURN propose applying 50% of these synergy savings to ratepayers pursuant to § 854(b). ORA thus calculates savings of $919 million and TURN calculates savings of $991 million. CTFC Witness Braunstein also presented testimony commenting on merger-related synergies. Although Braunstein did not prepare a separate calculation of synergy benefits, Braunstein believes that over $1.2 billion in short term and long

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22 Applicants claim the underlying data supporting the synergy calculation is confidential, as contained in Applicants' Supplemental filing, Exhibit 1.

23 These amounts are expressed in beginning-of-year 2005 dollars. TURN recommends that they be adjusted to beginning-of-year 2006 dollars to compute the correct basis for any payments to California ratepayers, which would not begin until calendar year 2006. Ex. 135C, Kientzle Reply Testimony, pp. 9-10, Revised Exhibit ERYK-2, Revised Exhibit ERYK-4, and Exhibit ERYK-5. ORA concurs, and SBC apparently does as well. Ex. 46C, Kahan Deposition Transcript, pp. 164-166.

term synergies are attributable to California from this merger. In reaching this figure, Braunstein agrees with the major adjustments made by ORA and TURN. Braunstein notes that the $1.2 billion figure is only a small fraction of the total overall synergies from the merger.

The ORA and TURN figures differ with Applicants figure by a considerable amount principally due to two adjustments: (1) the inclusion of SBC California operations in the synergies allocation and (2) extending the period over which ratepayer savings are measured to equal the period used by Applicants for evaluating shareholder synergies. ORA and TURN also propose various other adjustments that have a smaller impact on the calculation, as summarized below. We reach a determination on each of the proposed adjustments in the discussion below, and arrive at an adopted figure for the total synergy benefits to be allocated to consumers in accordance with § 854(b)(2).

Applicants also take issue with parties' disagreements over their calculation of synergies, characterizing it as "second guessing" the professional judgement of managers. We disagree with this characterization of opposing parties' critical inquiry into the synergies calculations. Opposing parties are entitled to examine all relevant documentation in an effort to validate any part of Applicants' modeling methodology. To the extent that the development of national synergies estimates were developed through due diligence and the "best business judgment" of SBC senior management, parties should be able to validate that due diligence and the methodology employed in developing specific estimates. Neither parties nor the Commission should have to take such estimates on face value in evaluating whether, and to what extent, this merger produces net benefits that are in the public interest.

D. Disposition of Issues Relating to Net Synergies Allocated To California Consumers

1. Definition of Short-Term and Long-Term for Measuring Ratepayer Benefits

a) Parties' Positions

As noted above, one of the largest factors accounting for the difference between the Applicants and ORA/TURN in measuring benefits subject to § 854(b) ratepayer sharing relates to the time period over which synergies forecasts are recognized. For purposes of their calculation of $27 million in California-specific synergies subject to ratepayer sharing, Applicants limited the time horizon to a five-year period. The $27 million represents the lump sum discounted present value of the stream of annual economic effects calculated by Applicants over the first five years of the post-merger period. Applicants recognized no distinction in their calculation between the "short term" and the "long term" (pursuant to § 854(b)) for purposes of allocating benefits to ratepayers.

Section 854(b), however, requires that there be both "short-term" and "long-term" consumer benefits from the merger. The statute does not provide a specific definition of what constitutes the short term versus the long term. Accordingly, we must establish such a definition for purposes of our § 854(b) analysis here. Based on the time period we establish as the short-term and long-term, we must then ascertain what, if any, merger benefits are expected to be realized over this period. Based on this factual determination, we must then make findings on whether the conditions of § 854(b) are adequately satisfied.

Although Applicants have provided no distinction between short-term and long-term with respect to benefits allocation, TURN argues that the projected costs of implementing the merger are likely to result in no net benefits for customers in the short-term, representing the initial years of the merger.

Although Applicants have calculated the California-specific synergy benefits by truncating the forecast time horizon after five years, the National Synergy Model forecasts additional merger synergies through the year 2013, and also includes an additional terminal value for synergies anticipated into perpetuity. The national merger synergies estimates were used as a basis to make representations to the financial community.[24]

The estimated costs to achieve the merger occur in the first initial years after the transaction, while offsetting savings are realized over a longer period. Using a five-year period for measuring California ratepayer synergies thus ensures that all of the initial merger costs are incorporated, while only a much smaller percentage of the offsetting savings forecasted by the National Synergy Model is included in the synergies allocated to California ratepayers.[25] As a result, ORA and TURN claim that Applicants' approach is unfair in truncating the calculation after 5 years because ratepayers are allocated none of the synergy benefits that Applicants have estimated will be realized on a national basis.[26]

ORA and TURN argue that Applicants provide no valid reason to limit the California-specific forecast of benefits to a shorter period than the one used by Applicants to calculate merger benefits to justify the Federal Communications

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[24] Ex. 126C, Reply Testimony of Lee Selwyn, p 62.

[25] Ex. 136C, Reply Testimony of Terry L. Murray, p 41.

[26] Ex. 127C, Reply Testimony of Hillary Thompson, p 11; Ex. 135C, Reply Testimony of Elizabeth R. Y. Kientzle, pp 5 and 9.

Commission (FCC) approval of the transaction.[27] ORA and TURN thus argue that the "long term" for purposes of allocating ratepayer benefits should coincide with the period used to assess synergies to be realized by shareholders. ORA argues that an economic definition of "long-term" should refer to the period of time after merger implementation costs were incurred, allowing all permanent synergy and other efficiency gains to be included in the calculation of merger benefits.[28] This definition of long-term coincides with the forecast period presented by Applicants to the financial community, even though Applicants use a five-year definition of long-term for ratepayer sharing.[29] Applicants claim that if the Commission uses the same definition of long-term used for Applicants' forecasts presented to the financial community, there will be an "inordinate risk upon the companies' financial operations and shareholders."[30]

ORA witness Selwyn testified, however, that the merger poses virtually no investor risk, while ratepayers will "confront[] an enormous risk because … the effect of this merger will … create a far less competitive market overall… [and] ratepayers and California consumers generally will see price increases."[31] ORA

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[27] Ex. 136C, Reply Testimony of Terry L. Murray, p 46.

[28] Ex. 126C, Reply Testimony of Lee Selwyn, p 13; versus the definition of "short-term" which is the transition period during which the combined company is being reorganized and restructured so as to implement the merger activities.

[29] Ex. 136C, Reply Testimony of Terry L. Murray, p 40, citing Kahan Exhibit 2; SBC Response to ORA 12-2.

[30] Opening Brief of Joint Applicants, p 46, citing Tr., vol. 13, at pp. 2068-2070, SBC/Aron.

[31] Tr, vol. 14, at pp. 2202-04, ORA/Selwyn.

thus argues that the Commission should not reduce ratepayer benefits to account for alleged shareholder risk by cutting off the calculation at five years and ignoring subsequent years projected benefits. Accordingly, ORA calculated the synergies attributable to California over the same time frame used by SBC for its shareholder and investor synergy disclosures.[32]

Alternatively, if the Commission were to adopt Applicants' five-year term for the purpose of attributing merger synergies to California, ORA proposes adjustments to avoid allocating a disproportionate share of merger-related costs to ratepayers. Because Applicants fail to capture a significant portion of the long-run cost savings used as a major justification of the proposed merger, ORA and TURN recommend that upfront merger costs be reallocated over a longer period to avoid a disproportionate allocation to consumers.[33] ORA witness Thompson performed a recalculation of the ratepayer share of benefits on this premise. ORA notes that once the five-year long-term limit is reached, the subsequent years account for 74% of the gross full national synergy benefits. ORA witness Thompson thus excluded 74% of the costs-to-achieve upfront as an alternative approach in the event that only a five-year period were adopted for measuring ratepayer benefits. This calculation would increase the California synergy benefits by $44 million.

b) Discussion

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[32] Ex. 127C, Reply Testimony of Hillary Thompson, p 11.

[33] Ex. 127C, Reply Testimony of Hillary Thompson, p 11; Ex. 135C, Reply Testimony of Elizabeth R. Y. Kientzle, p 9.

Section 854(b) requires that ratepayers receive benefits over both the short-term and long-term, but does not specifically define a duration for either period. In prior decisions analyzing § 854(b), we have held that the definition of long-term may vary with the circumstances of each individual case. (See, for example, D.91-05-028, 40 CPUC2d 159, 174; D.98-03-073, *mimeo.*, p. 14.) In this case, because ORA and TURN have utilized a longer duration in defining the "long term," they have captured a much larger magnitude of synergy-related savings that would be subject to § 854(b) ratepayer benefits. Although Applicants have prepared forecasts of potential synergies over a period longer, the Applicants' forecast horizon for making presentations to shareholders does not automatically dictate the period that we adopt for applying § 854(b) ratepayer benefits.

As previously noted in the SBC/Telesis decision, the level of competition is among the principal factors we consider in defining the long-term. (D.97-03-067, 71 CPUC2d 351, 375.) We consider the level of competition not only in a static sense (e.g., current market share, current number of competitors), but also in a dynamic sense (e.g., changes in market share; changes in numbers of competitors; the pace of change in technology, the industry, and the market, including regulatory changes).

The state of regulation and ratemaking is another factor in determining the long-term, and is as important a factor as competition. (D.97-03-067, 71 CPUC2d 351, 375.) We concluded in the SBC/Telesis merger decision that this factor supported 5.6 years. As we noted in the SBC/Telesis decision, the planning horizon is a secondary factor that may be considered in determining the long-term. (D.97-03-067, 71 CPUC2d 351, 374-375).

In reaching our decision here as to the time frame for quantifying benefits, we also consider how the long-term has been defined in other merger proceedings. One of the principles we have previously adopted is that the long-term must be determined for each individual merger based on the specifics of each case. Nonetheless, even though each was determined separately based on individual circumstances, we have tended to find about five years as the period for the long-term.[34] Perhaps the most similar recent merger was that of SBC/Telesis. We found the long-term there to be 5.6 years.

We also consider the period over which we may make a reasonable forecast, to ensure that we secure the total benefits for ratepayers that are required by § 854 while not exceeding our ability to reasonably predict the future. The pace of change and the inherent uncertainty in regulation, markets and technology led us to reject proposals for 10 and 20 years in the SBC/Telesis proceeding. (D.97-03-067, 71 CPUC2d 351, 375.). Consistent with our approach in the SBC/Telesis proceeding, we likewise decline to utilize such an extended time frame for defining the "long term" in determining § 854(b) net benefits. In consideration of these factors, we conclude that a six-year period is appropriate in defining the "long term" for purposes of applying net benefits to consumers applicable under § 854(b). A six-year period is reasonable in view of the approach we took in the SBC/Telesis merger in applying § 854(b) in which we used a 5.6-year period to define the "long term."[35]

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[34] We adopted a settlement, and found five years reasonable for the GTE/Contel merger. (D.94-04-083, 54 CPUC2d 258 (1994).) We found 5.6 years reasonable for the SBC/Telesis merger. (D.97-03-067, 71 CPUC2d 351.) We found five years reasonable for the Pacific Enterprises/Enova merger. (D.98-03-073.)

[35] A six-year period is in keeping with the SBC/Telesis time frame, rounded to the nearest whole year.

While we define the long term time as six years, we agree with ORA and TURN that Applicants' calculation produces a skewed result by deducting 100% of merger-related costs during the initial implementation in computing § 854(b) ratepayer benefits. Since the majority of the synergies associated with these merger costs are forecast to occur beyond the initial six-year period, the costs should be adjusted to assign a proportionate share to the period beyond the initial six years. We shall adopt ORA's proposal in this regard to allocate a pro rata share of the merger costs to the period after the initial six-years. Thus, because only a limited percent of Applicants projected synergy benefits are forecast to occur through the sixth year, we shall limit the same percentage of merger costs to the period through the sixth year.

2. Should Synergies Be Based Only on AT&T's Operations?

a) Parties' Positions

Another major difference in the ORA/TURN calculations of synergies has to do with whether SBC California operations are taken into account in allocating benefits. Assuming that the Commission applies § 854(b), Applicants believe that the Commission should only assess customer savings based only on AT&T's operation as the acquired company while ignoring any effects on SBC operations. ORA and TURN disagree, however, claiming that no provision of law supports limiting merger synergies to only AT&T operations. ORA argues that doing so would render the statute meaningless, since a transaction could always be designed so that the firm, affiliate or subsidiary subject to Commission review realized few of the benefits.

ORA and TURN argue that all AT&T and SBC California activities "where the Commission has ratemaking authority" should form the basis for the

§ 845(b)(2) allocation of benefits to California ratepayers.[36] Applicants' exclusion of SBC's California intrastate operations from the allocation of synergies to California ratepayers results in a substantial reduction in California-specific synergies. This effect occurs because of the far larger intrastate operations of SBC California and other SBC affiliates, which form the bulk of the merger synergies related to the combined post-merger California operations.

b) Discussion

We conclude that the proper approach to calculating ratepayers' share of synergies is to incorporate the effects of both utilities involved in the merger. Applicants argue that calculating merger synergies relating only to the firm being acquired is consistent with the approach followed in the SBC/Telesis merger. Yet, in the SBC/Telesis proceeding, the acquiring firm, SBC, had no significant California operations at that time. It made sense in that case to measure California specific synergies based solely on the company being acquired because it was the only entity with significant California-regulated operations. That merger proceeding however, did not address how to identify California-specific merger benefits when both the acquired and the acquiring company have substantial assets and operations in California. A similar principle applied in the Bell Atlantic/GTE merger. Thus, neither of those proceedings serves as precedent[37] for excluding SBC California operations from the merger synergies in this proceeding.

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[36] Ex. 127C, Reply Testimony of Hillary Thompson, p 12.

[37] Ex. 136C, Reply Testimony of Terry L. Murray, pp 48-49.

Furthermore, in the Bell Atlantic/GTE decision, the Commission found that a "greater portion of the savings associated with common cost functions will be achieved by the company that utilizes or consumes more of that function."[38] Consistent with this logic, the merger savings related to SBC's California operations are a valid component of the California-specific synergies subject to § 854 (b)(2).[39]

Public Utilities Code 854 (b)(2) expressly requires the Commission to "[e]quitably allocate[] . . .the *total* short-term and long-term forecasted economic benefits. . .of the proposed merger, acquisition, or control, between shareholders and ratepayers."[40] Thus, the totality of merger-related benefits must be considered, not merely the fraction attributable to one of the firms involved.[41] There are no exceptions in § 854 (b) allowing for exclusion of synergies relating to the acquiring company. The Commission has a duty to include all forecasted economic benefits.

The Commission's past practice has been to assess benefits based on all the firms involved in a transaction. For example, in the Southern California Gas Company (SoCal) and San Diego Gas and Electric Company (SDG&E) merger, (D.98-03-073) and in the GTE and Contel merger (D.94-04-083) proceedings, the

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[38] Ex. 136C, Reply Testimony of Terry L. Murray, p 49, citing D.00-03-021, 2000 Cal. PUC LEXIS 211, *36.

[39] Ex. 136C, Reply Testimony of Terry L. Murray, p 49.

[40] Ex. 136C, Reply Testimony of Terry L. Murray, p 50, citing P.U. Code Section 854 (b)(2), emphasis added.

[41] *Id.*

Commission determined ratepayer benefits by examining synergies realized by both the acquiring and the acquired companies.

Benefits from "synergies" necessarily involve the combination of the two companies in producing the benefits. Additionally, Applicants' publicly stated rationale for the merger, as presented to the financial community, places as much emphasis on benefits flowing to SBC from acquiring AT&T as they do on benefits moving in the other direction.[42]

We shall therefore determine the net benefits allotment to ratepayers based upon the total long-term benefits from the merger, as required by § 854 (b) considering savings realized by the combined California operations of both AT&T and SBC over a six-year period. ORA adjusted the California synergy calculation, adding the SBC California intrastate operations expenses to the AT&T California operations expenses, by using data from the SBC California intrastate operations report.[43] We shall adopt this approach, applied over a six-year period.

3. Inclusion of Expenses for UNE Services

Applicants did not include the cash operating expenses attributable to UNE services in their expense calculation applicable to AT&T-CA Services, claiming that UNE services were not part of the analysis[44] because the expense to provide these services is actually borne by SBC, not AT&T.

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[42] Ex. 136C, Reply Testimony of Terry L. Murray, pp 50-51.

[43] Ex. 127C, Reply Testimony of Hillary Thompson, p 12.

[44] Ex. 127C, Reply Testimony of Hillary Thompson, p 8.

ORA notes, however, that the National Synergy Model analyzes synergies associated with UNE services in areas such as wholesale headcount reductions,[45] thereby providing a basis for including the cash operating expenses attributable to UNE services in the expense calculation. ORA added UNE-related expenses back into the California synergy calculation. We find this adjustment reasonable, and hereby adopt it.

4. Double Counting of Wholesale Costs

ORA noted an error in the calculation of the allocation factor to identify the AT&T California share of the certain economic benefits of the merger derived from SBC's National Synergy Model. In calculating this allocation factor, Applicants double-count expenses related to wholesale services provided for each company by the other. The effect of double-counting results in a smaller allocation of annual synergies to California. We find this adjustment reasonable, and hereby adopt it.

5. Savings attributable to AT&T's reduced cost of capital

Applicants' calculation of synergies to be shared with California ratepayers excludes any savings attributable to reductions in AT&T's cost of capital. TURN witness Murray recommends that synergy savings be increased to recognize anticipated savings in AT&T's cost of capital, calculated by taking the current "spread" between AT&T's pre-merger cost of capital and SBC's post-merger cost of capital and applying it to AT&T's annual stand-alone capital expenditures. In response to SBC's criticisms of the calculation, Murray

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[45] Ex. 127C, Reply Testimony of Hillary Thompson, p 8.

subsequently refined her methodology using updated information and accounting for depreciation.

TURN witness Murray thus adjusted her calculation and reduced the synergies estimate. Applicants argue, however, that Murray's revised calculation still ignores Kahan's contention that any synergies from a reduction in AT&T's cost of capital would be offset and outweighed by significant up-front transaction costs of financing AT&T's debt at a lower rate.[46] While making this criticism, however, Applicants failed to quantify any of the claimed up-front refinancing costs. Moreover, Applicants' claim that such costs outweigh the savings contradicts their own claims that AT&T's reduced costs of capital is a benefit of the merger. Accordingly, Applicants' criticisms are not sufficiently explained or documented. We adopt TURN's cost of capital adjustment.

6. Overhead Transactions costs

TURN witness Murray identified certain categories of transactions costs included in the National Synergy model that remained unexplained with no apparent justification as to why they should be netted against merger savings in computing net benefits to be shared with ratepayers. TURN claims that to the extent that it can be inferred as to what the costs represent, they appear to be costs that should not be passed on to California ratepayers. TURN provides justification concerning its recommendation to exclude these costs in the confidential portion of the testimony of Terry Murray (see Exh. 135C, pp. 35-37).

We agree that the Applicants have failed to provide documentation or justification for applying these costs as offsets to derive the net savings sharable

[46] Kahan, Ex. 44, pp. 20-21.

with California ratepayers pursuant to § 854(b). Accordingly, we shall adopt the adjustments for these transactions costs described and summarized on pages 54 through 57 of the confidential version of TURN's opening brief.

7. Severance Costs

ORA witness Hieta testified that corporate salaries used to determine costs associated with the proposed merger were incorrectly fully loaded[47] when calculating severance payments and should be adjusted. Applicants also included in the national synergy model an offsetting cost to fund severance bonuses. As is the case with retention bonuses, ORA recommends that severance bonuses should be excluded in computing synergies. A main reason for the severance bonus is as reward for service and coercion to leave the company.

The Commission has previously determined that excessive payments for executives should not be funded by ratepayers. In D.04-09-061 the Commission did not have to declare what would reasonably be funded because it accepted SBC's proposal to voluntarily limit its executive compensation. The Commission also stated that "for its excess executive compensation costs, the Commission's affiliate transaction rules require that there be some benefit associated with an allocated cost."[48] The Commission has declared that there is precedent to *at least* cap payments to executives. Because Applicants have failed to produce justification for the claimed level of severance costs, we shall not require ratepayers to absorb them. ORA's adjustments here are adopted.

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[47] "Fully loaded" means that such costs as mileage reimbursement and lodging costs were incorrectly included in the base salary.

[48] D.04-09-061, *mimeo.*, pp. 84-85.

8. Exclusion of WilTel Contract Termination Costs

ORA argues that the Commission should exclude the WilTel contract termination cost from the National Synergy Model because the contract was terminated prior to the merger's close, rather than after, and that the cost would occur whether or not the merger occurs.[49] SBC responds, however, that it would not have terminated the WilTel contract absent the merger with AT&T. Otherwise, it would have had no network to use to complete the long distance calls for the millions of customers served by SBC LD nationwide – or even between San Francisco and Los Angeles.[50] We agree with Applicants' here, and ORA's adjustment is not adopted.

9. Investment Banking Fees

ORA contends that investment banking fees should not be included as an cost offset in the calculation of ratepayer savings.[51] SBC argues, however, that investment banking fees are a necessary transaction cost that would not have been incurred without the merger and without which the merger could not happen. ORA witness Johnston acknowledged on cross-examination that investment bankers fees were allowed as costs in the SBC-Telesis merger and the Bell Atlantic-GTE merger.[52] Consistent with prior precedent, ORA's adjustment here is not adopted.

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[49] ORA Opening Brief, p. 23.

[50] Rice (JAs) 10 Tr. 1395.

[51] ORA Opening Brief, p. 22.

[52] Johnston (ORA) 14 Tr. 2249-2250.

10. Revenues from CallVantage

With respect to this AT&T Voice over Internet Protocol (VoIP) application, TURN argues that "the Commission should include potential California revenues from this product in any benefits analysis."[53] TURN does not explain, however, how continuing to offer VoIP will provide intrastate California revenue synergies. Although Kahan admitted that consumer market revenue synergies would result from the combined entity's sales of VoIP.[54] Applicants claim that Kahan only conceded that it would represent a potential for a consumer market revenue synergy outside of California.[55]

Second, Applicants argue that the FCC has specifically held that VoIP is an interstate service and preempted states from regulating VoIP.[56] Thus, Applicants argue that revenue synergies that are both jurisdictionally interstate and that occur outside of California provide no basis for increasing the Applicants' calculation of California synergies.

We agree with Applicants that these savings are not properly included in the California synergies.

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[53] TURN Opening Brief, p. 43.

[54] TURN Opening Brief, p. 43.

[55] Kahan (JAs) Ex. 46C, p. 288.

[56] *In re Vonage Holdings Corp. Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, Memorandum Opinion and Order, FCC 04-267, WC Docket 03-211, ¶ 14 (rel. Nov. 12, 2004) ("*Vonage Preemption Order*") (ruling that the characteristics of some IP-enabled services "preclude any practical identification of, and separation into, interstate and intrastate communications for purposes of effectuating a dual federal/state regulatory scheme" and that such services are exclusively jurisdictionally interstate).

11. Inclusion of Capital and Revenue Synergies in Ratepayer Allocation

Applicants include only operating expense synergies in calculating the share of savings to be passed through to consumers under § 854(b), but have excluded capital expenditure and revenue synergies which, however, are part of the total economic benefits forecasted in SBC's own National Synergy Model. ORA and TURN incorporated these additional synergies in producing its alternative synergies calculation.

In his deposition, Kahan argued that any capital expenditures synergies associated with this transaction are interstate in nature since SBC and AT&T are combining national networks.[57] Accordingly, Kahan claims that such synergies should not be allocated to California ratepayers.[58]

Kahan also acknowledged, however, that there is an interrelationship between capital and operating synergies, and revenue and operating synergies. Nonetheless, Kahan did not study the extent to which those interrelationships exist in the model.[59] For example, there can be operating costs to achieve capital expenditure synergies, as well as general interrelationships between operating and capital synergies in integrating the networks of the two companies.[60] Rather than perform analyses to test the impact of these acknowledged

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[57] Kahan deposition at 69.

[58] *Id*. at 69, 82.

[59] *Id*. at 79-82.

[60] *Id* at 79-82.

interrelationships between synergies on the total California benefits, Kahan simply excludes capital and revenue synergies based on SBC's legal interpretation of § 854(b).[61]

These benefit categories have been included in prior Commission forecasts of the total short-term and long-term economic benefits of telecommunications mergers.[62] The history of prior SBC mergers also suggests that the operating expenses category is not necessarily the primary driver of synergies from such mergers.[63] Thus, we shall adopt the ORA adjustment here.

E. Adopted Synergy Benefits to be Allocated to California Consumers

Based on our findings discussed above regarding adjustments to Applicants' synergy calculation, we find Applicants' calculation of net benefits of $27 million significantly understates the level of synergies reasonably attributable to California utility operations. We agree with certain of the adjustments to the synergy calculation made by ORA and TURN, to the extent adopted in our discussion above. By applying the adjustments that we find reasonable, we calculate the amount of net synergy benefits applicable to

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[61] *Id.* at 68-76.

[62] Ex. 136C, Reply Testimony of Terry L. Murray, pg 28, referencing D.00-03-021, pg. 35, which found that "[t]here can be no reasonable doubt that revenue synergies are an economic benefit" when considering the proposed Bell Atlantic/GTE merger; D.97-03-067, pg. 49, which, disagreeing with SBC, found that "capital savings will accrue as a result of the merger" when considering the proposed SBC/Pacific Telesis merger.

[63] Ex. 136C, Reply Testimony of Terry L. Murray, p 28.

California for purposes of calculating § 854(b) shared savings amounts to be $659.2 million on a discounted net preset value basis.

We note that Applicants have entered into a settlement with Greenlining and LIF in which certain stipulated amounts of philanthropic contributions would be designated as the sole § 854(b) benefits to be adopted in this proceeding. Yet, the settlement does not purport to represent any quantitative analysis of actual synergies that would actually be realized through the merger. For reasons discussed below in Section V, we decline to limit § 854(b) benefits solely to those identified in the settlement.

In order to find that this merger is in compliance with § 854(b), we hereby require that 50% of the $659.2 million net synergies be shared with California consumers, resulting in an allocation of $329.6 million on a discounted net present value basis. This allocation to consumers complies with the directives of § 854(b) that at least 50% of the net benefits of the merger over the long-term be shared with California ratepayers. We address the implementation of the allocation of these consumer benefits in Section III.G below.

F. Ratemaking Authority to Implement Net Benefits Allocation

Applicants argue that irrespective of whatever level of merger savings may be attributable to California utility operations, the Commission should not impose a mandatory sharing of such benefits because the Commission does not have "ratemaking authority." Since AT&T and its affiliates are classified as CLECs and NDIECs, they are not subject to cost-of-service rate regulation. Accordingly, Applicants argue that because the utilities being acquired are not subject to rate regulation, the merger transaction, itself, is not subject to the purview of § 854(b)(2).

Applicants assert that the legislative history of Assembly Bill 119 of the 1995-1996 legislative session (AB 119) demonstrates that NDIECs and CLECs are exempt from § 854(b)(2)'s requirements.

ORA and TURN disagree. They point out that the language of the statute specifically refers to NDIECs and CLECs. California courts rightfully express "skepticism about looking beyond the statutory language when trying to discern the legislature's meaning." (*Pacific Bell v. Public Utilities Com*. (2000) 79 Cal. App. 4th 269, 280.) The Commission has looked to the extent of its regulatory authority as one factor justifying an exemption, under unique circumstances. For example, *AT&T and Media One*, supra, case does not establish that sharing doesn't apply to NDIECs or CLECs. Rather, it grants a § 853(b) exemption to a transaction involving an Internet Service Provider (ISP) because "internet services…are offered in an area generally unregulated by this Commission or any other State or Federal regulatory body." (Id., 2000 Cal. PUC LEXIS 355 at p. *23.) Other cases discussed in the Application Supplement, e.g., *MCI and BT*, *supra*, and *AT&T and Teleport*, *supra*, also involve the granting of a Section 853(b) exemption.

The fact that the regulatory status of a company is relevant to whether or not an exemption should be granted does not show that the statute automatically excludes NDIECs and CLECs from §§ 854(b) and (c) review. In any event, this transaction involves the acquisition—and removal from the market—of a very significant NDIEC and CLEC. It also involves an acquisition by California's largest ILEC. Thus, this transaction is not analogous to past proceedings where NDIECs and CLECs continued to participate in the market after the merger closed, and where no dominant ILEC was involved in the acquisition.

Applicants also cite *AT&T and McCaw Cellular* (1994) 54 CPUC 2d 43 (D.94-04-042) to support a claim that only "qualitative standards" should be used to assess any benefits of this transaction under § 853(b)(2). Applicants claim that American Tel. & Tel. and McCaw Cellular, *supra*, provides the Commission with authority to review only, "qualitative short-term and long-term benefits to consumers" because this transaction involves "entities over which the Commission does not exercise traditional ratemaking authority." (Supplement, at p. 4.)

a) Discussion

We conclude that we have ratemaking authority to implement the net benefits requirements of § 854 (b) (2). We conclude that approach we took in the AT&T/McCaw decision is not applicable here. That decision was rendered after several parties reached settlement, and before the record was developed. (AT&T and McCaw Cellular, supra, 54 Cal. P.U.C.2d at pp. 48-49.) The Commission's decision does not even use the word, "qualitative." The decision in that case was based on factors not present here. The AT&T/McCaw transaction, "even more than other recent mergers, is a paper transaction." The Commission also pointed out: "the merger involves two companies in essentially different lines of business, no consolidation of operations affecting the 15 McCaw California utilities is proposed at this time."

The Commission also noted that cost of service ratemaking did not apply to McCaw's California subsidiaries since they operated in fields that are largely competitive, and "our regulation of these fields is correspondingly relaxed." (*AT&T and McCaw Cellular, supra,* 54 Cal. P.U.C.2d at pp. 50-51.) By contrast, SBC is a dominant carrier subject to price regulation through the New Regulatory Framework (NRF) procedure. Particularly for customers without clear competitive options, the only way that they can be assured of net benefits from the merger is through a mandatory pass-through of savings. There is no assurance that market forces will flow through savings to such customers.

The SBC/AT&T merger therefore is not analogous to the AT&T/McCaw merger. SBC/AT&T merger is expected to produce quantitative benefits, and there is no need to retreat to a qualitative standard.

Moreover, in the prior cases where we did not apply § 854(b)(2), both the acquired and the acquiring company were not subject to rate regulation. In this case, however, SBC California is an ILEC subject to the Commission's ratemaking authority through the NRF mechanism. Thus, the exemptions from § 854 (b) noted in the previous transactions that exclusively involved NDIECs/CLECs do not apply here where we exercise price regulation over the surviving company.

We previously addressed the question of whether market forces can be relied upon to pass through merger savings to customers in reviewing the SBC/Telesis merger. In D.97-03-067, we observed that the markets in which SBC/Telesis planned to operate were, at that time, at varying degrees of competition. We found that, at least for Category I and Category II services, they were not sufficiently competitive to conclude that any merger savings would be passed through as a result of market forces. As a result, we included these services in the calculation of savings to be shared between ratepayers and shareholders. On the other hand, we excluded all savings associated with Category III services from our calculations of savings to be shared between ratepayers and shareholders.

G. Measures to Implement Pass-Through of Synergy Benefits to Consumers

Having found that § 854(b) applies to this merger, we address the specific means by which the identified net benefits shall be passed through to consumers.

ORA and TURN did not formulate specific proposals concerning how the net benefits should be allocated among different groups of consumers. ORA and TURN do agree, however, that merger savings to be shared with ratepayers need not all necessarily flow through as rate surcredits. ORA witness Selwyn characterized ratepayer benefits as “currency” to “spend” on various mitigation measures. ORA believes that proposals for the uses of shared benefits be subject to examination and further comments. ORA and TURN propose that the specific allocation of the net benefits among different consumer groups and interests be addressed in a separate phase of this proceeding.

Also various other parties and individuals at the PPHs have advocated that any net benefits be earmarked for designated purposes, such as in funding programs to help bridge the “digital divide” experienced by the various underserved elements of the communities in which SBC provides service. In this regard, we are also separately adopting certain conditions pursuant to § 854(c) relating to philanthropy commitments by SBC, as discussed in a subsequent portion of this decision.

Thus, in order to provide a proper basis upon which to determine how net consumer benefits from the merger should be distributed, we will adopt the ORA/TURN proposal to take further comments on this issue. Before determining the specific allocation of net benefits adopted herein, we solicit comments to be filed 20 calendar days following the effective date of this decision concerning proposals for the specific allocation of the net benefits among consumer groups and/or other programs for the benefit of consumers. Following receipt and review of comments, we shall proceed with further steps to implement the distribution of net benefits to consumers as adopted in this decision.

ORA and TURN have also proposed that additional measures be implemented concurrent with approval of this merger, to mitigate the risk that any net ratepayer benefits that might otherwise be realized might be taken away through rate increases.

Given the potential for short-term benefits to be eroded by rate hikes for captive customers, TURN and ORA recommend that Applicants be required to:

1. Maintain a five-year rate freeze for residential and small business basic local exchange services, include 1FR, 1MR, 1MB customers. ORA adds residential inside wire maintenance plans to the list of services.
2. Make the above services available to consumers on a stand-alone basis without any requirement to purchase other bundled services.
3. List the separate availability of these services prominently (noting that there is no requirement to purchase other bundled services) in their phone books and in any advertising on Web sites or through bill inserts.
4. Retain a pricing option for California-jurisdictional long-distance calling that does not have any minimum monthly charge or fee.

Underserved consumers, including low-income, minorities, and those with disabilities are particularly concerned about the trend of companies offering telecommunications services in bundles to residential consumers, and the resulting impact on the affordability of basic phone service. Because consumers with disabilities are disproportionately represented among low-income consumers, they have a particular interest in ensuring that basic and affordable telephone service will be provided by the new entity. To effectively serve the disability community, the new merged entity must ensure that the increased marketing of bundled services does not inflate the price of basic service, which low income individuals, including people with disabilities, may prefer.

We shall adopt the recommendation of ORA and TURN for a five-year cap on the residential and small business basic exchange services, including inside wire maintenance plans, as identified above. By adopting this recommendation, we will mitigate the risk that residential and small business ratepayers would have their rates increased to pay for the short-term implementation costs of the merger. This adopted measure is thus necessary to provide assurance that ratepayers realize merger benefits over the short term, rather than being at risk for rate increases to pay for the merger. We shall also adopt the recommendations to make these basic services available on a stand-alone basis, to separately list the service in their web sites and through bill inserts, and to retain a pricing option for long-distance calling with no minimum monthly fee. These conditions shall remain in effect during the five-year rate cap period.

IV. Competitive Impacts of the Merger Under Section 854(b)(3)

A. Framework for Assessing Competitive Impacts

1. Applicability of Section 854(b)(3)

Consistent with our analysis above relating to the sharing of net benefits under §§ 854(b)(1)and (2), we likewise find that that this transaction is subject to § 854(b)(3) requirements that competition must not be adversely affected. In accordance with § 854(b)(3), as a prerequisite for authorizing the merger, the Commission must find that applicants' proposal does not adversely affect competition. For the reasons previously discussed above, we reject Applicants' arguments that this transaction is not subject to § 854(b)(3) merely because the utility transfer is being structured around holding companies.

It would elevate form over substance to conclude that the Legislature was more concerned with competition if the utility was a party to the transaction absent the holding company structure, but was less concerned about competition when a holding company was involved. We therefore determine that § 854(b) applies to this acquisition even though it is configured merely as a holding company transaction. Accordingly, we proceed with our analysis of competition in accordance with § 854(b)(3).

In the Southern California Edison Company (SCE)/San Diego & Gas Company (SDG&E) merger proceeding (D.91-05-028; A.88-12-035), we set forth analytical precedents and tools for interpreting whether a party's proposal "adversely affects competition" within the meaning of § 854 (b)(3). We noted therein that the more familiar merger analysis is whether "the effect of such acquisition may be substantially to lessen competition or tend to create a monopoly" under Section 7 of the Clayton Act. (Id, 40 CPUC2d at 182.) Precedent developed under Section 7 of the Clayton Act provides a framework for analyzing competitive effects under § 854(b)(3), as well as subsequent proposals, under the federal antitrust laws.

While we are guided by federal antitrust law (e.g., Section 7 of the Clayton Act) in analyzing the SBC/AT&T proposed merger, we do not need to find a technical violation of that law in order to deny the proposed merger.[64] Rather, under § 854, we may disapprove a merger where the impacts are harmful, but

[64] See D.97-03-067, 71 CPUC2d 351, 379; also see D.91-05-028, 40 CPUC2d 159, 182.

less than "substantial" under the Clayton Act. (D.97-03-067, 71 CPUC2d 351, 379.) In analyzing a proposal under § 854, we are not limited to a determination that the proposal violates standards set forth in the relevant antitrust statutes. We may also rely, as appropriate, on the body of common law regarding competition that existed before 1989, when the required standard of review for mergers meeting the specified criteria was codified for utilities in §854.

Independent of § 854, however, the Commission still has an obligation to assess the antitrust impacts of matters before us. *Northern California Power Agency v. Public Util. Com*. 5 Cal3d 379-380 (1971) requires that the Commission take into account the antitrust aspects of applications before us, but based on a balancing test, "plac[ing] the important public policy in favor of free competition in the scale along with the other rights and interests of the general public."

Section 854(b)(3) obligations are more specific, however, and do not provide for a balancing test. For mergers that come under § 854(b)(3), the Commission must make a finding that as a basis for approval that competition will not be adversely affected. The Legislature further mandated certain, specific outcomes if it is determined that such a merger will adversely affect competition. Thus, the Legislature required that mitigation measures be adopted to avoid adverse impacts, or else that authorization for the merger be denied.

2. Methodology for Assessing Competitive Impacts

The Department of Justice/Federal Trade Commission Horizontal Merger Guidelines (*Merger Guidelines)* provide a well-developed and widely accepted process for factually evaluating how a proposed merger will affect competition.[65]

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[65] Ex. 136C, Murray Testimony, pp. 64-66.

The Merger Guidelines set forth a sequence of analysis beginning with a definition of relevant markets followed by an assessment of whether the merger would increase market concentration in the relevant markets. (*Merger Guidelines* § 0.2.) Accordingly, we shall proceed with our analysis by referring to the Merger Guidelines, as appropriate.

As an initial step in analyzing whether the merger will have adverse effects on competition, we must relate potential impacts to the relevant markets within which a firm might exercise market power to the detriment of competition. For purposes of assessing potential competitive effects of the merger, SBC witness Aron broadly delineates the mass market (i.e., residential and small business customers) and the business market (other than those within the mass market) with the latter including an enterprise segment.

TURN witness Murray provided a more granular definition of the relevant markets for purposes of assessing potential competitive impacts of the merger. On the retail side, Murray presented evidence of the following distinct markets in SBC California's service area: (1) primary network access connections for residential customers; (2) all other residential services, including additional lines; (3) services for small businesses; (4) services for mid-sized businesses; and (5) services for very large (enterprise) business customers.[66] On the wholesale side, TURN recommends that the wholesale and interconnection services be considered both for traditional circuit-switched voice and IP-based services.

Applicants' own business practices typically treat each of these markets separately, and each market has the potential to be affected in different ways by

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[66] Ex. 136, Murray Testimony, § III.D.

the merger. For purposes of our analysis, we will therefore assess the effects of the merger with respect to each of more granular markets, as delineated by TURN.

Our inquiry focuses on evidence as to whether or not this proposed merger increases or otherwise enhances market power with reference to the relevant markets as identified below. Applicants' existing level of market power is the base from which our competitive analysis begins. We recognize, however, that the existing base is only a starting point, and that prospective developments expected in the competitive landscape must be considered and weighed in an appropriate manner.

We thus consider whether or not the proposed merger will adversely affect competition with respect to each of the relevant markets, considering the effects of AT&T as an actual or potential competitor. We also consider the appropriate weight to give the Advisory Opinion of the Attorney General.

3. Jurisdiction to Address Impacts Involving Federally Regulated Services

Since both federal agencies and this Commission are reviewing the proposed merger's public interest aspects, certain jurisdictional questions have been raised. Parties disagree concerning whether Commission review of competitive impacts under § 854 (b)(3) properly includes consideration of impacts that may involve services subject to federal regulation or review. Applicants argue that competitive impacts of such services are beyond the jurisdiction of this Commission, and are more properly left for review by federal agencies.

We conclude that even to the extent that certain competitive effects of the merger may relate to services subject to federal regulation, our authority under

§ 854 (b) and (c) is sufficiently broad to encompass consideration of such effects. Section 854 (b) (3) requires, as a basis for approving this transaction, that we consider whether the proposed acquisition will adversely affect competition, as well as conditions to mitigate adverse impacts. The statue does not carve out exceptions to this requirement only for certain categories of services or competitive impacts.

We previously confirmed our jurisdiction to review competitive impacts and adopt mitigating measures under § 854(b), even where our review may involve federally regulated services. For example, in D.91-05-028 involving the SCE merger with SDG&E, the applicants there argued that the FERC had jurisdiction over transmission and sale of electric energy in interstate commerce, and that federal jurisdiction is plenary. SCE claimed that this Commission may not act in a manner that would conflict with a federal determination. Since the FERC had chosen to exercise authority to determine the competitive impacts of that merger on such federally regulated services, SCE argued, this Commission's review must be limited to state-regulated services which FERC did not regulate.

In D.91-05-028, however, the Commission rejected SCE's interpretation, stating that:

> "This Commission's statutory authority to determine whether the proposed merger should be authorized, based upon the assessment of competitive impacts and their potential mitigation (§ 854(b)(2)) is meaningfully exercised only if this Commission is free to engage in the <u>full extent of the merger's impacts</u> on California ratepayers. The statute requires that we assess whether the merger will impact competition. If that assessment requires us to take into account certain issues regarding interstate transmission and bulk sales, <u>then that is what we must do.</u> Furthermore, as an administrative agency created by the Constitution, <u>we have no power to refuse to</u>

> enforce § 854(b)(2) on the basis of federal preemption, unless an appellate court has made a determination that enforcement of the statute is prohibited by federal law or federal regulation. (Cal. Const. Act. 3, § 3.5. (40 CPUC 2d, 159, 179.) (Emphasis added.)

Applicants here raise the same argument as that raised by SCE. Although the SCE proceeding involved a different industry, the same principle is involved. Consistent with D.91-05-028, therefore, we find that the statutory mandates under § 854(b)(2) require consideration of the full extent of competitive impacts of the merger, including impacts that involve federally regulated services and prices.

Moreover, Joint Applicants cite no appellate court determination that the Commission's enforcement of § 854(b)(3) is prohibited by federal law or regulation. Thus, consistent with D.91-05-028, the Commission has no power to refuse to enforce § 854 based merely on Applicants' claims of federal preemption.

To the extent that we impose conditions on approving this proposed merger, we do so only within the context of our obligation to assure that the merger is in the public interest pursuant to § 854. If the Applicants decided not to go forward with the merger, they would not be required to implement the mitigation measures we adopt. Thus, we are acting within the scope of the Commission's jurisdiction under § 854(b)(3).

4. Relevance of Market-Share and HHI Data in Assessing Merger Impacts

For assessing market concentration, the *Guidelines* rely upon calculations utilizing the Herfindahl Hirschman Index (HHI) as an analytic 'starting point' in all merger reviews. (AG Opinion, at p. 16, citing *Merger Guidelines* § 90.) The HHI is a measure that is used to draw inferences concerning the correlation between market concentration and lack of market competitiveness. Under DOJ guidelines, if the HHI for a market is greater than 1800 and if the proposed merger increases the HHI by more than 100, the rebuttable presumption would be that there is an increase in market power associated with the merger.

a) Parties' Positions

Applicants did not provide market share statistics as the basis for its claims that competition will not be adversely affected by the merger, and did not perform an analysis of market concentration utilizing the HHI.[67] Although Dr. Aron points out what she views as weaknesses to the conventional market share calculations submitted as evidence by other parties, she does not perform any such calculations herself. (Ex. 79C, p. 22, SBC / Aron.) Witness Aron claims that there is no value to calculating market shares because such statistics are not meaningful in this marketplace at this time. (Aron Rebuttal, page 22.)

AT&T is the single largest competitor of SBC in all three major segments of the California telecommunications market – local residential and small business services, long distance, and services to large business, government and institutional "enterprise" customers. ORA argues that SBC's acquisition of AT&T translates into significant escalations in the HHIs applicable to the SBC California local and long-distance markets.[68] These increases exceed the

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[67] The HHI is a measure of market concentration calculated as the sum of each firm's squared market share, with higher HHI values representing more concentrated markets.

[68] Ex. 126C, Table 1, p.51, Selwyn/ORA.

thresholds specified in the *Merger Guidelines*.[69] ORA views these increases in market concentration as creating the opportunity for post-merger SBC to implement a "significant and non-transitory increase in price."

SBC witness Aron disagrees with ORA witness Selwyn that the HHI analysis should be controlling in assessing the competitive impacts of this merger. Even where the HHI analysis is otherwise applicable, Dr. Aron characterizes it as only a preliminary screen to identify those cases where further analysis is warranted. Particularly in the case of the mass market, Aron believes that market share data is not meaningful here because AT&T has already withdrawn from competing for mass market customers. Aron therefore believes that there would be no effect on market concentration as a result of AT&T being absorbed by SBC since AT&T is no longer actively competing in the mass market. Dr. Aron likewise argues that because the HHI is a summary of market share data, the HHI suffers from the same shortcomings as market shares themselves.

TURN presents evidence that SBC has a highly concentrated share of the market, particularly for mass market customers. TURN witness Murray performed a detailed market share analysis, set out at Exhibit 136C, pp. 75-110. Murray identified a number of relevant product markets.

SBC does not deny that current statistics indicate a highly concentrated market share, but argues that such statistics are not meaningful indicators of the effects of the merger on competitiveness of the market. SBC witness Aron criticizes intervenor witnesses' testimony on market concentration, arguing that

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69. Merger Guidelines, at §1.5(c). The Merger Guidelines consider a market with an HHI greater than 1800 to be "highly concentrated," and state that "[m]ergers producing an increase in the HHI of more than 50 points in highly concentrated markets post-merger potentially raise significant competitive concerns ..."

they have misapplied the DOJ Merger Guidelines by focusing on a "backward-looking, formulaic 'checklist'." SBC witness Aron argues that such historic data on market concentration portrays an unrealistic profile of the competitiveness of the market based upon forward-looking information. In particular, Dr. Aron points to trends in intermodal competition and the rapid pace of technological development in the industry as more relevant indicators of the extent of market competition.

b) Discussion

We conclude that the proper approach to a competitive analysis requires recognition of recorded data on market concentration, including HHI measures, as a necessary starting point.[70] We disagree with Dr. Aron to the extent that she claims historic data on market concentration has no value whatsoever. Dr. Aron did not perform her own market concentration analysis. We find her analysis incomplete in this respect.

Once a traditional calculation of market share has been calculated, other prospective factors, such as those considered by Dr. Aron, are taken into account. For example, changing market conditions are considered "in interpreting market concentration and market share data," but not as a reason to discount such data entirely. (*Merger Guidelines* § 1.521.) Similarly, the possibility that new firms might enter the market is to be considered either when a market is defined, or after a market concentration analysis has been performed. (*Merger Guidelines* §§ 0.2, 1.132 3.2.)

[70] Ex. 79C, p. 8, SBC / Aron.

As discussed in further detail below, we generally find that as a starting point for further analysis, the HHI measures for each of the markets reviewed by ORA and TURN indicate a high degree of concentration. In those markets in which SBC and AT&T are active competitors, the HHI measures indicate that market concentration will increase sufficiently to warrant concerns about the potential for competition to be impacted. With the HHI findings as the starting point, the next step is to consider whether other forward-looking measures of competition lead to a different conclusion concerning the competitive effects of the merger.

With respect to forward-looking competition from traditional wireline carriers, we generally find little evidence that such competition can be relied upon to mitigate increased market power as a result of the SBC/AT&T merger. SBC witness Aron claims that because of the "impetus" caused by the phase-out of UNE-P, facilities-based competition will increase. Yet, the UNE-P phase-out led AT&T to exit the mass market rather than to compete by constructing more facilities. (Ex. 14, p. 5, Polumbo/AT&T). Likewise, SBC preferred to buy AT&T rather than to build its own facilities to compete against AT&T. (Tr. 10: 1045; SBC/Rice). These actions by the two largest competitors in California raise serious doubts as to whether traditional wireline carriers with less financial resources than SBC or AT&T will have the incentive to build their own network facilities to compete against the merged company.

The remaining question is whether we can rely on forward-looking competition from newer intermodal alternative technologies to conclude that the merger will not pose competitive problems. We consider this question in detail below. We then consider what conditions may be warranted to mitigate the potential adverse competitive effects of the merger.

5. Weight to be Given the Attorney General's Advisory Opinion

a) Background

As directed by § 854(b)(3), the Commission requested an advisory opinion from the California Attorney General (AG) concerning whether competition will be adversely affected by the merger, and, if so, what mitigation measures might be adopted to avoid this result. While the AG's opinion is not controlling, we shall accord it due weight in our deliberations.[71]

The AG Advisory Opinion was filed on July 22, 2005. In analyzing the competitive effects of the merger, the AG employed the approach embodied in the antitrust laws, including the DOJ and FTC 1992 Horizontal Merger Guidelines and the April 8, 1997 revisions. 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.

In summary, the AG expresses concern that the merger may adversely affect competition for two types of special access, namely, DS1 and DS3 services. The AG concludes that the merger may have the effect of raising average rates for DS1 and DS3 service. As a mitigating condition of merger approval, the AG thus recommends that rates paid by current AT&T customers receiving DS1 or DS3 private line network service be frozen for a one-year period. On the other hand, the AG concludes that the competitive effects of the proposed merger will

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[71] D.97-03-067, 71 CPUC2d 351, 420, footnote 31. Also see Attorney General's Opinion, page 3, citing Moore v. Panish (1982) 32 Cal.3d 535, 544, and Farron v. City and County of San Francisco, (1989) 216 Cal.App.3d 1071.

be minimal for other relevant markets, including those for mass-market local and long distance, enterprise, and Internet backbone services.

The AG Opinion relied primarily upon written FCC materials, on testimony submitted in this proceeding and on materials provided by Applicants with no opportunity for ORA, TURN or competitors to reply. (Tr. Vol. 8, p. 1045 AT&T/Giovannucci.)[72] The AG's Opinion was released before evidentiary hearings, and thus did not consider evidence resulting from the hearing, including additional information produced as exhibits, the results of two depositions, and cross-examination of witnesses. In addition, it is unclear whether the AG had the benefit of reviewing the documents provided by Applicants to the FCC Staff.

The AG Opinion concludes that SBC and AT&T mainly compete in different telecommunications markets or in entirely different sectors of the same market.[73] This conclusion is a result of the AG Opinion's assumption that it should only analyze facilities-based competition between SBC and AT&T in certain markets. (AG Opinion, at p. 14.) These markets include the residential and small/medium business markets for both local exchange service and long

[72] The staff of the AG's office held on-site meetings and conference calls with the Joint Applicants and with several of their witnesses, but did not hold similar meetings or telephone conferences with ORA or TURN. (Counsel of ORA is only aware of several telephone conversations between ORA and the AG's office, on the topic of obtaining documents being withheld by Applicants. The staff from the AG' Office also attended a presentation by XO to ORA.) Some of the material supplied to the Attorney General's office by Joint Applicants was admitted as Exhibits 5C, 6C and 7C.

[73] The AG Opinion makes one exception to this conclusion: the DS1 and DS3 special access markets.

distance service.[74] Even though both AT&T and SBC, "offer local, access and toll service within SBC service regions…. includ[ing] information services, business switched access, and long distance services," (AG Opinion, at p. 6.) the opinion does not consider the effects of this competition.

b) Discussion

We conclude that, by focusing its analysis on facilities-based competition, the AG Opinion did not fully address the overall markets for telecommunications services. In addition, because AT&T and SBC pursue different business strategies, only looking at facilities-based competition pre-determines the results of the analysis for mass market local exchange and long distance services. The analysis for other markets is also affected by the opinion's assumptions.

Because it focused only on facilities-based competition, the AG Opinion determines that the lack of overlap in facilities between SBC and AT&T allows it to avoid a "precise determination" of Applicants' market shares. (AG Opinion, at p. 16.) As a result, the AG Opinion does not calculate the changes to the HHI as a result of this transaction. In analyzing only facilities-based competition between SBC and AT&T, the AG relies on a technical theory derived from the FCC's decision approving the MCI/WorldCom merger.[75] Thus, the AG Opinion can only be relied upon to show the results of applying the FCC's *WorldCom/MCI*

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[74] The AG Opinion uses this theory in its discussion of the special access markets as well.

[75] *Re Application of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control, etc.* (1998) 13 FCC Rcd. 18,025 ("*WorldCom/MCI*").

standard to the transaction. In this respect, we find the AG Opinion relatively incomplete compared to testimony provided by other witnesses who did perform the required analysis set forth in the *Merger Guidelines.*

The AG Opinion does not define product markets to include the products actually offered to customers, but analyzes the markets for the "inputs" from a "vertical dimension" that make up the services offered. The AG's opinion analyzes these inputs because they may be "more limited than the end product." In this case, the AG Opinion concludes that only one so-called "input," services offered by carriers using their own facilities need be analyzed to determine this transaction's competitive effects. By declining to analyze the broader market where telecommunications companies compete for customers limits the scope of the AG Opinion's analysis.

We conclude that the facts underlying the *WorldCom/MCI* decision are not sufficiently analogous to warrant the adoption here of such a restrictive approach. A competition analysis determines if a transaction has the ability to create or to enhance market power. The *Merger Guidelines* suggest that market power be measured by defining specific product markets that could be monopolized. (*Merger Guidelines §1.1.*) Defining a product market involves identifying alternatives that should be included in the relevant market, and product markets should not be defined too narrowly.

An exercise in market definition should take into account products whose presence could make price increases unprofitable. (*Ibid.*) As a result, focusing only on competition for facilities-based services defines the market too narrowly. When a dominant facilities-based local exchange carrier absorbs the market share of another carrier, it is not clear that the dominant carrier's resulting increase in market share is irrelevant simply because the absorbed carrier was a reseller.

Similarly, if a carrier that resold long distance was able to obtain a significant share of the market at the expense of a facilities-based carrier, the competition between those two carriers should not be discounted simply because one is a reseller. The AG Opinion does not explain how its chosen market definition accounts for the fact that the bulk of the competition in California's local exchange and long distance markets occurs between carriers who use different strategies.

The AG Opinion appears to equate facilities-based competition with competition at a wholesale level. The AG describes products combining "a range of inputs" in support of its conclusion that readily available inputs need not be analyzed. (AG Opinion at p. 14.) The Opinion focuses on a "commercial level" to assess "supply constraints," and discusses "output levels" that are determined by the market conditions facing "suppliers". (AG Opinion, at p. 17.) Facilities-based carriers, however, do not necessarily compete with each other to supply resellers, but may prefer to use their facilities to supply their own customers. SBC has overwhelming dominance of the local exchange distribution ("last mile") and local interoffice transport facilities. (Ex. 126C, at p. 73 ORA/Selwyn.) SBC has only been reselling those facilities as a result of a regulatory mandate that was rescinded following *United States Telecom Ass'n v. FCC* (2004) 359 F.3d 554. Thus, correlation between facilities-based services and services available at wholesale is not always apt.

Moreover, by excluding CLECs using UNE-P or long distance resellers from the analysis, the AG Opinion does not analyze the effect this merger will have on the potential for new entrants in the facilities-based market. Because AT&T currently serves this market via UNE-P, the AG Opinion reaches its conclusion about the effect of removing AT&T from the market without analyzing AT&T's potential as a facilities-based entrant. "Because we conclude that the relevant market is for facilities-based services, we do not consider…whether [AT&T] can still be considered an active supplier of…services." (AG Opinion, at pp. 17-18.)[76]

The AG Opinion's focus on facilities-based services also does not address the fact that SBC will increase its market shares. SBC controls much of the critical last mile infrastructure in California. Because of SBC's already-dominant position, the elimination of its largest competitor should not be minimalized simply because AT&T uses UNE-P for its local exchange services.

Accordingly, we will not rely primarily on the AG Opinion, but will also give substantial weight to parties' expert testimony proposing further conditions.

B. Effects of the Merger on Specific Markets

1. Effects on the Mass Market

a) Parties' Positions

Applicants argue that the merger will have no affect on competition with respect to mass market customers. As one line of evidence supporting this claim, Applicants contend that AT&T withdrew from the mass market for economic and competitive reasons that were independent of its decision to merge. Although AT&T continues to serve its existing mass market customers, it has stopped competing for new mass market wireline customers. Thus, Applicants

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[76] The record on AT&T's withdrawal from the mass market was significantly augmented after the AG Opinion was issued in the deposition of AT&T witness Polumbo, and at the hearing. The AG Opinion, however, was unable to consider the effect of this transaction in determining the amount of new facilities-based competition that might develop

argue that market concentration statistics are not relevant with respect to the competitive effects of the merger on the mass market, since AT&T would not have been an active participant in the mass market “absent the merger.” (Ex. 78C, p. 57, SBC/Aron, Ex. 79C, p. 34, SBC/Aron.)[77] Applicants further argue that in any event, SBC’s mass market prices will continue to be constrained by existing and emerging active competitors whose competitive activities are unaffected by the transaction.

ORA and TURN disagree with the claim that actual data on market concentration has no value in assessing the competitive effects of the merger. TURN witness Murray presented evidence that market power within the mass market is highly concentrated. Murray separately segmented the mass market into more granular market segments, and calculated concentration statistics for each segment. Murray thus separately calculated HHI measures both for the residential mass market for primary service connections and for secondary lines. Murray calculated that in the market for primary connections, SBC’s pre-merger HHI increases significantly. The HHI increase calculated by Murray significantly exceeds the 100-point threshold in the Merger Guidelines beyond which it is “presumed that mergers…are likely to create or enhance market power or facilitate its exercise.”[78] Murray testified that regulators should be very concerned about likely adverse effects on consumers and competitors when a merger results in such a large HHI increase, particularly in a highly concentrated market.

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[77] Aron (JAs) Ex. 78, pp. 59-61; Aron (JAs) Ex. 79, pp. 30-61.

[78] Merger Guidelines, Section 1.51

TURN acknowledges that the market for secondary telephone lines for "all other residential services" is more competitive than the market for primary network access connections. Unlike the primary line market, participants in this market may include the full spectrum of intermodal competitors, including cable-based telephony, VoIP, and cellular. Applicants provided no factual data regarding the HHI or other measures of concentration for this market. Although TURN was unable to locate quantitative data for this market sector, TURN presented evidence to suggest, based on the closest available data, that this market is also likely to remain significantly concentrated.[79]

TURN also observes that as competition becomes increasingly focused on offering high-end bundles of services, competition will further slow because "bundled" customers may be unwilling or unable to switch carriers in response to price changes. In other words, multiple products are "sticky" and it is much more work for customers to switch companies once they have moved multiple services into a single bundle, as compared to the ease of switching stand-alone long distance carriers.

Applicants do not dispute the mathematical accuracy of the HHI calculations performed by TURN, but claims that such statistics are not relevant here because AT&T had already exited the mass market independently of the merger. Thus, Applicants argue that SBC's acquisition of AT&T would cause no net change in market concentration. Applicants also fault the use of HHI data as being "backward-looking." Murray testified, however, that even if "forward-

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[79] Ex. 136C, Murray Testimony p. 89, and Ex. 2, Attachment to Applicants' Response to TURN 1-t at 003603-003606.

looking" market shares were as low as 43%, the market for primary network access connections still would be highly concentrated. Murray claims that no evidence has been brought forward suggesting that SBC's post-merger market share would drop that low in the foreseeable future.

ORA and TURN question the claim that AT&T exited irrevocably from the mass market independently of the merger. ORA argues that no one knows for certain how AT&T would have behaved "absent the merger." At the time it withdrew from the Mass Market, AT&T had a highly profitable mass market business. In response to regulatory changes, AT&T was considering various options, including mergers. In other contexts, Dr. Aron considered other companies of a similar level of profitability to be entrants or competitors in the market. (Tr., Vol. 12, p. 1789, SBC/Aron.)

ORA claims that absent the merger, AT&T's business profitability would give it a clear incentive to compete. When AT&T decided to stop marketing its "consumer services" products, it appeared to be a relatively healthy business. AT&T witness Polumbo confirmed that at "the time point when AT&T made the decision to stop marketing to the mass market, that was, in fact, the peak, of AT&T's all-distance customer base." (Tr., Vol. 9, p. 1241, AT&T/Polumbo.) He also confirmed that the business was profitable and would have continued to be so. (Tr., Vol. 9, pp. 1241-1242, AT&T/Polumbo.) Polumbo agreed that the consumer services arm of AT&T was more profitable than the business arm (although he tried to explain this as an artifact of accounting). (Tr., Vol. 9, p. 1238, AT&T/Polumbo.)

ORA believes that AT&T's decision to stop marketing its consumer services products at the height of their success was based on a strategic evaluation of AT&T's perception of the future of its business. AT&T appeared to have considered a number of different business approaches. (Tr., Vol. 9, p. 1215, AT&T/Polumbo.) At the same time AT&T was actively considering "every opportunity, every option" to acquire, merge or be merged into another company. (Tr., Vol. 9, p. 1230, AT&T/Polumbo.)

ORA notes that two decisions were made by AT&T at a July 21, 2004 board meeting: (1) to withdraw from the mass market and pursue a "harvest" strategy,[80] and (2) to seek a merger with SBC. (Tr. Vol. 9, pp. 1234-1235, AT&T/Polumbo.) ORA views these as contingent decisions made by seasoned board members and executives in real-time, and if the underlying facts were different, their decisions might have been different. SBC witness Kahan stated that AT&T could, successfully, have built a local loop network. (Tr., Vol. 11, p. 1581, SBC/Kahan.) ORA thus challenges Applicants' claim that AT&T's exit from the mass market would have necessarily occurred absent the merger.

b) Discussion

We conclude that the mass market, particularly for residential primary connections, was already highly concentrated even prior to the merger, and will remain so after the merger. As discussed in detail in Section V.B.3, we do not find that the residential market, particularly for primary connections, is robustly competitive as a result of intermodal service options. Particularly for the underserved sectors of the SBC customer base, the market is not highly competitive due to intermodal options.

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[80] The decision to withdraw from the mass market was a decision to stop marketing those services, not a decision to abandon existing customers. The term "harvest" strategy refers to a plan to retain mass market customers while at the same time increasing prices so the revenue those customers generated increased. (Tr., Vol. 9, p. 1229, AT&T/Polumbo.)

On the other hand, we agree that at least the residential and small business market for secondary lines and services is somewhat more competitive through intermodal options. Nonetheless, even here, while intermodal competition is growing, its effects are not presently widespread enough to mitigate all of the competitive concerns of the merger. We find that ubiquitous intermodal competition remains a future hope rather than a present reality. Dr. Aron agreed that her analysis did not focus on whether firms are offering service today. (Tr. 12:1789/ SBC/Aron). Instead, her analysis looks to the future potential of a firm to offer competitive services. Yet, to the extent the hoped-for expansion of intermodal options is a future event, we must address the need for mitigating conditions in the interval between now and the future when such competition may be fully realized.

At the same time, while we find that SBC already has a highly concentrated share of the market, we acknowledge that the acquisition of AT&T will not significantly change the degree of concentration, at least for the mass market, since AT&T effectively withdrew from actively competing for this market independently of its decision to merger. Although ORA and TURN raise questions as to whether AT&T might have theoretically resumed competing for the residential mass market absent the merger, we find the evidence reasonably persuasive that AT&T did not intend to reenter the mass market in any event.

Nonetheless, we find it significant that a company with the resources of AT&T chose to withdraw from the mass market rather than compete against SBC. Such a withdrawal by AT&T does not paint a picture of robustly competitive conditions for remaining competitors of SBC. Thus, given the high degree of preexisting market concentration, we agree that regulatory measures are needed to assure that such customers with few or no competitive options benefit from the merger, or at the very least, are not disadvantaged through rate increases to fund the implementation of the merger.

2. Effects on the Business Market

a) Parties' Positions

Applicants claim that the merger will not adversely effect competition in the business segments of the market.[81] Applicants claim that SBC's and AT&T's services are complementary, rather than overlapping. SBC's market focus is on small and medium-sized businesses with a high percentage of their locations in SBC's 13 in-region states.[82] AT&T's focus is on large multi-location businesses nationwide and globally.[83] Applicants argue, therefore, that the merger of SBC and AT&T does not remove a significant competitor of the other in these business segments.[84] SBC claims it has encountered difficulty expanding its out-of-region sales to enterprise customers, including enterprise customers with a national reach, and lags behind the enhanced and differentiated offerings that competitors in the enterprise market are able to provide.[85]

Even in instances where AT&T and SBC may compete for the same customers, Applicants claim that customers will still have other firms competing

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[81] Aron (JAs) Ex. 78, pp. 59-73; Aron (JAs) Ex. 79, pp. 61-81.

[82] Kahan (JAs) Ex. 43, pp. 11-12, 16.

[83] Polumbo (JAs) Ex. 14, pp. 16-17; Kahan (JAs) Ex. 43, p. 12.

[84] Aron (JAs) Ex. 79, p. 79.

[85] Kahan (JAs) Ex. 43, pp. 14-16.

to meet their communications needs,[86] including traditional carriers and newer entrants with alternative networks including wireless, broadband Internet, cable telephony, and VoIP.[87]

Applicants do not define separate markets for residential and small business customers, and do not separately address how the merger will affect the small business sector. Yet, Applicants do not deny that both SBC and AT&T are both currently major active competitors for these customers. Although Applicants likewise declined to present an HHI analysis, TURN used data obtained from SBC to develop its own HHI analysis separately for the local small business market sector.[88] TURN defines the small business category as comprised of customers spending less than $500 per month on telecommunications services. AT&T, however, has defined "small business" customers more broadly as those spending $2,500 or less on such services.

Witness Murray testified that the degree of post-merger concentration in the small business market and the magnitude of the increase in competition from the Applicants' pre-merger market shares suggest that the proposed merger would be "likely to cease or enhance market power or facilitate its exercise" even if AT&T had a considerably smaller market share than it currently does.[89] In the small business market, Murray computed that SBC's HHI increases significantly

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[86] Aron (JAs) Ex. 78, pp. 64-72; Aron (JAs) Ex. 79, pp. 65-73.

[87] Aron (JAs) Ex. 78, pp. 64-72.

[88] Ex. 136C, Murray Testimony, Ex. TLM-4

[89] Ex. 136C, Murray Testimony, Ex. TLM-2, Applicants' Response to TURN 1-36.

as a result of the merger. In medium business market, HHIs also increase by significant amounts. (Ex. 136C, Exhibit TLM-3.)

As noted by TURN in its brief, Applicants own data suggest that the proposed merger will materially decrease competition for services to mid-sized businesses.[90]

TURN argues that the evidence indicates that SBC can more than "hold its own" when competing in the large business customer (i.e., enterprise) market absent the proposed merger. Both ORA and TURN present evidence that SBC and AT&T are currently competing head-to-head for enterprise business throughout the SBC footprint, and extensively in California. ORA contends that the merger will virtually eliminate competition for retail enterprise customer business within California and the other twelve SBC in-region states.[91] In its response to FCC Staff data request No. 4, Applicants provided data on situations where SBC and AT&T were in direct competition for specific enterprise customer business covering a period of approximately seven months, from October 2004 through April 2005. In those seven months, SBC and AT&T competed to provide service to several thousand enterprise customers, including several hundred in California. In the overwhelming majority of these sales situations, AT&T and SBC were the *only* competitors identified as having submitted a proposal for the requested services.

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[90] TURN Opening Brief, page 90.

[91] Exhibit 126.1-C.

b) Discussion

We conclude that the merger, without mitigating conditions, will increase the market power of the SBC in the business market. As with the residential market, we conclude that the market concentration for small and medium business customers was already high before the merger, and will continue to be high after the merger. While AT&T has ceased competing for mass market customers, they still compete for medium and large business customers. The HHI measures computed by TURN witness Murray are informative as to the potential for the merger to increase market concentration in the business sectors of the market. Although Applicants claim that there is abundant competition for enterprise customers from other possible competitors, they have not presented convincing evidence demonstrating that any of those competitors are able to capture any significant portion of the market now, or in the future once AT&T is eliminated as a separate competitor.

We examine below the claims made by parties concerning whether, or to what extent, intermodal competition serves as a sufficient market force to neutralize any adverse anticompetitive effects that might otherwise result from the elimination of AT&T as a major competitor. As discussed in further detail below, however, we are not convinced that intermodal competition is yet sufficiently developed as an adequate market force to constrain ILEC pricing in the medium business or enterprise markets. SBC has reiterated its desire to be allowed to immediately increase basic business service rates in the concurrent Uniform Regulatory Framework proceeding, arguing that it should be allowed to do so with only one-day notice to the Commission. TURN thus infers that SBC is aware that it already possesses sufficient power in this market to impose a general rate increase without losing ground to competitors. The only evidence offered by Applicants to suggest that competition will not be harmed for this market segment are extracts from press releases and web sites suggesting that certain competitors claim they would like to offer service to mid-sized business customers.[92] Accordingly, we agree that certain mitigating conditions are warranted in order to mitigate any adverse competitive effects of the merger. We consider in further detail in Section IV.C the specific proposals for mitigating conditions for different market segments, and decide which ones are appropriate to adopt. In the following section, we review the evidence concerning claims of intermodal competition.

3. Intermodal Competition as a Mitigating Factor

a) Overview

SBC argues that it faces robust competition from intermodal carriers in California, and as a result, competition will not be adversely impacted by its acquisition of AT&T. As evidence of intermodal competition, SBC witness Kahan testified that SBC has experienced a decline in access lines due to various forms of intermodal competition over the past five years.

Intervenors dispute SBC's claims of intermodal competition as speculative and anecdotal. TURN witness Murray argues that Applicants' claims about intermodal competition relate to projections five or more years in the future, but do not demonstrate a serious competitive threat in the next two or three years, particularly for the small business and low-volume residential market.

[92] Ex. 79, Aron Rebuttal Testimony, pp. 67-73.

SBC has made similar claims for nearly a decade which have yet to come true. (Ex. 136C, p. 68, TURN / Murray.) In the 1995 NRF review, Pacific Bell's expert testified about intermodal competition, relying "on the same type of data Dr. Aron relies on today…analyst…and company [statements] that cable and wireless competition was just about to sway in." (Ex. 136C, p. 69, TURN / Murray.)

CTFC Witness Braunstein testified that wireline residential and business voice access are in distinctly different markets from wireless telephony and VoIP. Braunstein testified that wireline and wireless markets provide different mixes of features and serve different sets of users. While some customers may choose to subscribe both to wireline and wireless services, or even to substitute one for the other in some cases, Braunstein claims that does not automatically place them in the same market.

Dr. Aron presented broadly based testimony on intermodal comption, but did not assess relevant differences in how the merger will affect competition for intermodal services available to small and medium businesses in second and third tier markets within different geographic markets within the state. Aron defends the qualitative data she presents as commonly accepted in antitrust and merger analysis. She offered no information, for example, as to which carriers, including AT&T, operated at the retail and / or wholesale level in second and third tier markets in the California Central Valley or Central Coast regions.

As discussed in further detail below, we remain unconvinced that Applicants have made the case that intermodal technologies offer a competitive substitute for SBC wireline customers. It is not sufficient merely to count allegedly competing entities or the subscriber shares of intermodal entities in confirming the existence of competition. The relevant test of competition from intermodal sources is whether those sources have had an effect on SBC's wireline pricing or demand. We do not find that evidence of such pricing effects has been shown. Accordingly, we find that SBC's increased market power from the acquisition of AT&T is not mitigated by intermodal competition.

b) Competition from Cable Telephony

(1) Parties Position

Applicants claim that intermodal competition from cable telephony will be a significant factor in assuring that the telecommunications markets remain competitive even with the acquisition of AT&T. SBC witness Aron testified that cable companies already have made a significant sunk investment in upgrading their networks for telephony, and/or have investment activities already in progress. Thus, where such investment has been made, Aron reasons, the economic motivation of cable-based telephony is to grow its telephony business rapidly to turn the sunk investments into revenue streams. Aron testified that cable companies have told their investors that they intend to seek substantial telephony penetration, and are rolling out service nationwide. While different cable companies may expand telephony offerings at different rates, Aron believes, based on industry analyst reports, that cable telephony offerings are here now, and will only increase.

(2) Discussion

We are not persuaded that competition from cable telephone is sufficiently developed to mitigate competitive concerns.

The two largest cable providers in California are Comcast and Cox. In her rebuttal, Aron provides a map of California showing the areas covered by cable modem service with overlays indicating SBC wire center territories and areas in which cable modem service is available. Comcast is, by far, the largest cable operator in the SBC California service territory. Aron conceded, however, that Cox, a cable provider whose use of VoIP she relied upon in testimony, has a small presence in California's Central Valley. (Tr. Vol. 12, pp. 1787-788 SBC / Aron.) Dr. Aron also did not know if Cox offers business services in the Central Valley, but only that the company was "interested and eager," and had been successful in the past. (Tr. Vol. 12, p. 1788, SBC / Aron.) With respect to Comcast, another large cable provider, Dr. Aron stated on cross-examination that it intended to provide a VoIP service in the residential market "within a year or so from now." (Tr., Vol. 12, p. 1894, SBC / Aron.) Aron conceded that even the initial deployment of a business service from Comcast would take twice as long.

Aron disputes Selwyn's claim that any "stalling" of cable telephony would indicate reduced future competition. Aron believes any such stalling merely reflects a strategic change from relatively less efficient circuit-switched cable telephony to more efficient VoIP telephony.

A study from Deutsche Bank anticipates major growth in cable telephone service within a decade, with penetration of 20 to 25 million subscribers nationwide. Analysts at USB Securities predict 1.6 million new cable telephone subscribers during 2005 and expect Cox to achieve close to a 25% telephony penetration among cable subscribers where it offers cable service. Kahan testified that Cox has subscribed 40% of the households that it serves in its San Diego service territory to its Cox Digital Telephone service.

Yet, cable's role as competition to SBC is essentially limited to those geographic markets already served by cable companies with an interest in competing with local exchange services. Cable companies moreover generally deploy their facilities to reach only residential customers. (Ex. 78C, p. 62, SBC / Aron.) Also, cable companies that do intend to provide communications service to business are subject to certain geographic limitations, as noted above. Dr. Aron acknowledges that cable companies can only reach commercial customers in "suburban areas" because "cable assets have been traditionally deployed with residential customers in mind." (Ex. 78C, p. 62, SBC/Aron.) Aron's analysis, however, did not address the limitation of intermodal competitors within specific markets, in particular cable companies. As a result, we do not view cable competition as ubiquitous at the present time, especially for the business segment. As ORA witness Selwyn testified, even to the extent that cable-based competition were to become widespread throughout California, a cable/ILEC duopoly would not provide sufficient competition to constrain SBC from using its market power in pricing its services.[93]

c) Competition from Independent VoIP Providers

(1) Parties Position

Applicants' Witnesses Kahan and Aron testified that the rapid development of broadband connections has facilitated the emergence of independent VoIP service providers. These independent VoIP service providers are presently adding about 400,000 subscribers per quarter and are projected to accelerate their growth to 4 million next year. TeleGeography predicts roughly a doubling of VoIP subscribers during 2005.

Kahan testified that cable companies, some of which started offering traditional telephony services around 2000 are also offering VoIP telephony. The major cable operators have either launched a VoIP product or announced

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[93] Ex/ 126C. Selwyn Testimony, p. 121.

deployment plans and are promoting VoIP as a replacement for ILEC wireline telephone service. Cox, for example, serves approximately 40 percent of existing Cox cable television customers with telephone service in its Orange County, California service territory.[94] Although cable voice service was traditionally provided over circuit-based switches, major cable operators are moving into VoIP and other IP-based services.[95] Analysts predict that the "introduction of VoIP, especially by cable companies, represents the largest long-term threat to the Bells."[96] Forecasts show that VoIP consumer connections nationwide are forecast to rise from approximately one million residences in 2004 to more than 17.5 million in 2008.[97] Analysts also estimate that by the end of 2005, cable-provided VoIP will be marketed to more than 40 percent of all U.S. households,[98] and that nearly two-thirds of American homes will have cable telephony (either VoIP or circuit-switched) available to them.[99]

Witness Aron also points to competition from VoIP services from providers like Vonage, Packet8 and Skype.[100] These VoIP services are generally available anywhere a customer has a broadband connection, and the provision of

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94 Aron (JAs) Ex. 78, p. 29, n.63.

95 Aron (JAs) Ex. 78, pp. 25-31.

96 Aron (JAs) Ex. 78, p. 27, n.49 (citing Morgan Stanley).

97 Aron (JAs) Ex. 78, p. 27.

98 Aron (JAs) Ex. 78, p. 28.

99 Kahan (JAs) Ex. 43, p. 9. Analysts expect that approximately 81% of American homes will have cable telephony available to them by the end of 2006.

100 Aron (JAs) Ex. 78, p. 28, 31-33.

service is not dependent on the underlying broadband provider.[101] In the first quarter of 2005, Vonage added 200,000 subscribers, and already serves nearly 600,000 subscribers.[102] Aron testified that such VoIP offerings exert competitive pressure on traditional telephone services.[103]

(2) Discussion

We conclude that while use of VoIP is growing, it is not yet sufficiently developed to serve as a competitive check against ILEC wireline offerings. As of the end of 2004, there were fewer than 1 million residential VoIP subscribers nationwide,[104] constituting less than 1% of residential voice lines. Also, AT&T is one of the major providers in this market through its Call Vantage service. Thus, VoIP competition from that source will be eliminated through the merger.

ORA points out, moreover, that customers of pure play VoIP providers must have a broadband connection at high rates.[105] To the extent the broadband connection comes from SBC, it will be bundled with a land line. (Ex. 126C, p. 93, ORA / Selwyn.) If the broadband connection comes from a cable firm, the extent of the competition provided will be limited to the geographic footprint of the cable television franchise. AT&T currently offers a VoIP product. (Tr. Vol. 9,

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[101] Aron (JAs) Ex. 78, pp. 28, 31-32.

[102] Aron (JAs) Ex. 78, p. 28-29.

[103] Aron (JAs) Ex. 78, pp. 31-32.

[104] Ex. 78, A.16

[105] The prevailing monthly broadband rates are $42.95 for cable (see Ex. 95) or $49.95 for SBC DSL (See Ex. 71). Although SBC offers a $14.95 introductory rate for DSL, this rate is only for one year for new customers who also sign up for SBC local voice service.

p. 1273, AT&T / Polumbo) Post-merger, the combined entity will also offer VoIP. (Ex. 12C, pp. 61-62, ORA / Tan.) ORA witness Tan also points out that revenue SBC-California lost to VoIP would in fact be earned by an unregulated affiliate of SBC in this scenario. SBC can leverage its last mile facilities to compete more effectively for customers in unregulated areas. (Ex. 12C, p. 63, ORA / Tan.) Currently, it is not possible to obtain broadband access (a necessary prerequisite for VoIP) from SBC without maintaining a wireline from SBC. Similarly, SBC's wireless and wireline operations include combined sales channels. AT&T's own witness Polumbo provided evidence that VoIP still suffers from limitations as a competitive alternative to wireline service. Polumbo testified that VoIP was a different service from wireline, as opposed to a substitute. (Tr., Vol. 9, p. 1274, Polumbo / AT&T.) Polumbo pointed out that VoIP was "limited" by the amount of broadband penetration, which he estimated to be 30% of customers. (Tr. Vol. 9, p. 1275, AT&T / Polumbo.) He also pointed out that it cost three times as much to market VoIP as compared with wireline. He explained that the service was so complex customers were confused and needed extensive—and expensive—hand-holding from customer support. (Tr., Vol. 9, p. 1275, Polumbo,AT&T.) Questions about E911 services, and various surcharges are still to be resolved for VoIP. (Ex. 126C, p. 126, ORA / Selwyn.)

d) Competition from Wireless Technologies

(1) Parties Position

Applicants also point to wireless carriers as an additional source of intermodal competition which will mitigate any competitive concerns regarding the acquisition of AT&T. SBC Witness Kahan testified that the migration of customers from wireline to wireless service providers constitutes evidence of a significant source of competition. As a result of wireless competition, Kahan argues that customers will continue to have competitive choice even with SBC's acquisition of AT&T.

Applicants argue that industry observers expect wireline access lines to continue to decline on a national basis during the next several years. Kahan believes this trend will hold true for California as well. Between 1999 and 2004, SBC California reported a loss of about 22% of its residential and single-line business lines, and its multi-served business lines decreased by nearly 26%.[106] In view of the overall growth of California's economy and population over the same period,[107] Kahan attributes these declines in the number of SBC's access lines to competition from wireless providers. While wireline access lines has been declining in number, wireless subscribers in California has been growing–from 8.5 million in December 1999 to 21.6 million by June 2004.[108] In addition, the average price per minute for wireless service has declined from $0.18 to $0.08 on a national basis.[109] Recent trends indicate that for every three additional wireless connections there is the loss of one wireline access line. The

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[106] Aron, Ex. 78, p. 42

[107] California's population grew 6% from 2000 to 2004. U.S. Census Bureau, 2004 Population Estimates. Its economy grew 20% over the same period. U.S. Department of Commerce, Bureau of Economic Analysis.

[108] FCC, "Local Telephone Competition-Status as of June 30, 2004," rel. Dec. 2004, Table 13.

[109] FCC, "Trends in Telephone Service," May 2004; Deutsche Bank, "US Telecom Data Book 3Q-04," Nov. 2004.

number of wireless connections now exceeds wireline access lines in California.[110] About 5-6% of the U.S. population has "cut the cord."[111]

ORA's witness introduced evidence, however, that these line losses were merely attributable to customers' decision to buy broadband service instead of dial-up connections to the internet. (Ex. 126C, p. 122, ORA / Selwyn.) Dr. Selwyn also explained that the analyst report cited by Applicants was not authoritative. (Ex. 126C, pp. 105-107, ORA / Selwyn.)

In addition to displacing access lines, wireless has siphoned revenues off the wireline network. Nationally, wireless customers make 60 percent of their long distance calls on wireless phones rather than on their "landline," and wireless customers substitute their wireless phones for 36% of local calls.[112] While the bulk of the research on these trends reflects national data, Kahan believes that California trends would not be materially different.

TURN disputes Applicants' claims, however, concerning wireline losses. TURN claims that much of the wireline loss merely reflects a reclassification of the line from regulated basic exchange service to nonregulated broadband Digital Subscriber Line (DSL) service. Such line loss would therefore not reflect the effects of competition, but merely the transfer from use of one technology to

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[110] Competitive Enterprise Institute, "Wireless Substitution and Competition," Dec. 2004, p. 9; FCC, "Local Telephone Competition: Status of June 30, 2004," rel. Dec. 2004.

[111] FCC, "Ninth Annual CMRS Competition Report," Sept. 9, 2004, ¶ 212 and fn 575; The Yankee Group, "Youth Market Will Drive Wireless-Only Households," Dec. 2004.

[112] The Yankee Group, "The Success of Wireline / Wireless Strategies Hinges on Delivering Consumer Value," Oct. 2004

another by a single company, and consolidates market power. TURN argues that SBC's statistics on line losses do not indicate a mass defection of business customers to competition, but, in large measure, merely a migration from switched access lines to high-speed, high-volume special access lines.

SBC witness Aron concedes that the current numbers attributable to wireless substitution are "modest." (Ex. 78C, pp. 22, 23, SBC/Aron (2%).) Dr. Aron believes, however, that there is evidence of robust competition from wireless (Ex. 78C, p. 23, SBC/Aron.) from a so-called "flow analysis." Flow analysis relies on the potential future effect if a current situation persists over time.

Aron presented the results of a study by Deutsche Bank estimating that nearly half of primary residential lines lost by ILECs are going to wireless. Analysts at UBS have made similar observations. Thus while conceding that the overall percentage of customers who have "cut the cord" may be relatively small, Aron argues that the competitive impacts in terms of the rate of outflow of customers to wireless is a full order of magnitude greater. Thus, Aron claims that to focus merely on the percentage of wireless-only customers is misleading by understating the impacts of the rate of customer loss to wireless. Aron believes that the rate of migration to wireless is of sufficient magnitude to concern wireline managers in making their pricing decisions.

Dr. Aron attests to the legitimacy of this form of flow analysis by referring to the FCC's proceedings in the ATT/Cingular merger. (Ex. 79C, p. 27, SBC/Aron.) Aron admitted, however, that the FCC declined to use "flow share approach" and instead used a modified HHI calculation in the ATT/Cingular case. (Tr. Vol. 12, p. 1885, SBC/Aron.) Reliance on flow analysis is also called into question by the fact that the trend in line loss is downwards. SBC witness

Kahan admitted that "SBC California's losses of retail residential primary lines have decreased substantially." (Tr. Vol. 11, p. 1566, SBC/Kahan.) He stated that such line loss "peaked in the fourth quarter of '02." (*Ibid.*) Dr. Aron's claims rest on the potential of wireless service to eventually compete with wireline services. Yet, we find it significant that the trend in line loss is different from the trend line upon which Dr. Aron relies.

(2) Discussion

We conclude that "wireless substitution" has not yet developed for landline telephone service sufficiently to rely upon it to neutralize any concerns as to the elimination of AT&T as a competitor. (Ex. 126C, pp. 95-101, ORA/Selwyn.) ORA witness Selwyn testified that Dr. Aron's theories of wireline-to-wireless substitution were inaccurate because she had not shown any cross-elasticity of demand between the two services. (Ex. 126C, pp. 109-111, ORA/Selwyn.) The AG Opinion likewise concluded that "we are not persuaded that the cross-elasticities of demand between wireless and landline services are particularly high."[113] Selwyn showed these cross-elasticities were extremely small. (*Id.*, at pp. 98-101.)

Dr. Aron's testimony on wireless service focused on residential customers (Tr., Vol. 12, p. 1789, SBC/Aron.), although she did state that business customers were, "increasingly interested in both mobile wireless and fixed wireless service to enhance and provide for their telecommunications needs." (Tr. Vol. 12,

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113 AG Opinion, at 17.

pp. 1789-1790, SBC/Aron.) Aron, however, makes no attempt to break out the extent to which business is interested in "enhancing" rather than replacing its wireline service with wireless products.[114] The Attorney General, TURN witness Murray, CTFC witness Braunstein, and ORA witness Selwyn all concur that wireless services should not be included in the same product market as wireline services, at least for primary access lines.

Applicants state that there were 21.6 million wireless connections in California in June 2004. (Application, page 27). Yet, as pointed out by CTFC witness Braunstein, one cannot assume that all of these connections represent competition with Applicants' wireline service in general, or residential wireline service, in particular. The total reported wireline connections include an unspecified number within the territory of Verizon and other smaller ILECs that would not reflect competition within the SBC territory. The wireless data also fail to delineate connections attributable to large business customers that would still have wireline service on their desks and at the residences of their employees. The data also include an unspecified number of subscribers to Cingular and AT&T Wireless, entities that are owned, at least in part, by the Joint Applicants. For these reasons, we find the reported data on wireless connections does not provide persuasive evidence that wireless presently offers a viable competitive alternative to wireline service for a large cross section of SBC wireline customers.

Dr. Aron fails to take into account any negative factors that will limit the future development of intermodal competition. VoIP, and cable telephony all

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[114] This statement also merges fixed wireless (a data service) into wireless voice service. Combining such different services overstate the interest of business customers in "cutting the cord."

rely on an external power source and do not have the reliability track record of traditional wireline services, especially in emergencies and natural disasters. (Tr. Vol. 15, p. 2292, TURN/Murray.) In California, with its risks of earthquakes and/or fires, this is an important limitation. Wireless service has limited coverage, often hindered by terrain and other factors. (Ex. 104, 105.) Neither wireless service nor VoIP service includes fee listing in the white pages. (Tr., Vol. 12, p. 1913, SBC/Aron.)

Moreover, many of the services Dr. Aron identifies as evidence of intermodal competition will also be offered by the new merged entity and its affiliates. To that extent, transition to intermodal wireless technologies does not necessarily indicate competition from other companies, but may also simply indicate the movement of customers between technologies within the same company.

Line losses due to customers leaving SBC wireline service to subscribe to Cingular do not represent competitive losses, at least to the extent of SBC's ownership interest in Cingular. Customers migrating to wireless will not even leave the SBC umbrella of companies, but will simply be served by a different affiliate, such as Cingular. SBC's ownership interest in Cingular is 40%. Cingular, however, does compete with four other national wireless carriers within California statewide and with several other smaller wireless providers. SBC's marketing personnel do not track customers who migrate to a wireless provider to distinguish between customers that select Cingular versus another competitor. With the exception of Verizon Wireless, these other wireless carriers are independent of RBOCs.

Thus, intermodal wireless competition is not sufficiently developed in all markets, or throughout California, to the point where it can be relied upon to serve as an effective check against SBC's market power as a result of the merger.

C. Mitigation Measures to Address Adverse Competitive Effects of the Merger

1. Price Caps to Mitigate Resource Imbalance

a) Parties' Positions

Witness Gillan testified on behalf of both CALTEL and Cox. Witness Gillan testified that the removal of AT&T and MCI through the mergers will create a resource imbalance in bargaining power that will disadvantage SBC's competitors. Gillan characterizes the merger as essentially recreating the vertically integrated design of the pre-divestiture Bell System, except without the regulatory protections that existed before. The merger will result in a historically unprecedented concentration. Although the pre-divestiture AT&T once owned all of the Bell Operating Companies (and, therefore, arguably represented a greater concentration than SBC and Verizon have achieved), AT&T managed those resources through 22 separate operating companies that each enjoyed some measure of local autonomy.

Gillan claims that the resource imbalance created by this merger (together with that of Verizon-MCI) fundamentally disrupts a core assumption of the federal Act, namely, that entrants and incumbents would be able to arbitrate as equals. Gillan contends that with the loss of AT&T (and presumably MCI) as major independent advocacy voices, CLECs will no longer be able to adequately advocate for themselves, and that local competition will be undermined as a result without the mitigating protection of price caps.

Gillan therefore proposed that as a condition of approving the merger, the Commission adopt "price caps" for network elements that must be made available under both Section 251 and section 271 of the Telecommunications Act. CALTEL argues that such price caps will more efficiently regulate network element pricing and act as a transitional path to less regulation.

Applicants claim that CALTEL witness Gillan identifies no plausible rationale for his pricing cap proposals. Applicants deny that a "resource imbalance" will result from the merger with the elimination of AT&T as a regulatory advocate for CLEC interests. Applicants claim that this Commission will be fully capable of implementing its duties under the 1996 Act. Gillan argues that the revenues of ILECs outweigh the revenues of the so-called "competitive sector." *See* Gillan (CALTEL) Ex. 131, p. 14. Yet, in making this calculation, Gillan omits from the "competitive sector" the cable providers that offer telephony service over their ubiquitous networks.

Applicants claim that as applied to rates for network elements that must be made available pursuant to section 251, CALTEL's proposal is contrary to the 1996 Act's requirement that such rates be "based . . . on cost."[115]

Under CALTEL's proposal, UNE rates would be set initially at the levels the Commission has put in place today, and then be reduced automatically, year-after-year, to account for productivity improvements that SBC California might realize. Applicants argue that rather than being "based . . . on cost" as the 1996 Act requires, CALTEL's proposal would call for a percentage deduction applied each and every year to account for cost savings CALTEL asserts that SBC

[115] 47 U.S.C. § 252(d)(1).

California will realize. Applicants argue that nothing in the 1996 Act or FCC rules countenances that result.

Applicants argue that CALTEL confuses the issue by interchanging the distinct principles behind price caps and those behind Total Element Long Run Incremental Cost (TELRIC) pricing. Under price caps, a regulator makes a calculation of actual, current costs, and then puts in place a formula for calculating the productivity improvements, with an offset for inflation, that are expected to occur over time.

Applicants argue that under TELRIC, by contrast, state commissions are charged with making a hypothetical determination of the forward-looking cost of a given element, using the most efficient technology available.[116] Unlike in the price cap context, Applicants argue that there is no basis for imposing an annualized reduction. Applicants claim that it is impossible to know whether, under TELRIC, the most efficient technology will be any different (or cheaper) each subsequent year. Applicants argue accordingly that there is there is no basis for imposing a price cap regime in that context.

Applicants likewise argue that CALTEL's price cap proposal is equally unlawful, as applied to facilities that must be made available pursuant to 47 U.S.C. section 271 but not section 251. Applicants claim that state commissions have no jurisdiction to implement or enforce section 271. Congress granted "sole authority to the [FCC] to administer . . . section 271."[117] Applicants

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[116] *See* 47 C.F.R. § 51.505.

[117] Memorandum Opinion and Order, *Application for Review and Petition for Reconsideration or Clarification of Declaratory Ruling Regarding US West Petitions To*

Footnote continued on next page

argue that the *only* provision in the 1996 Act that contemplates state-commission ratesetting authority is section 252, and that provision does *not* authorize state commissions to establish rates for elements and services required under section 271. Section 252 authorizes state commissions to set rates *only* "for purposes of" *section 251*.[118] As the FCC has explained, with respect to state commissions' authority to set rates for network elements, section 252 is "quite specific" and "*only* applies for the purposes of implementation of section 251(c)(3)."[119] Applicants thus dispute CALTEL's basic contention that this Commission may establish rates for facilities that are required to be made available solely under section 271.[120]

Applicants further argue that CALTEL's proposal conflicts with the FCC's substantive rules regarding the pricing of such facilities. CALTEL proposes that the Commission establish section 271 rates using the FCC's TELRIC-based transition rates – *i.e.*, the rates the FCC has said apply to elements that, under the *Triennial Review Remand Order*, are no longer required under section 251, for the period until March 11, 2006 during which CLECs can use those elements to serve their existing customers.[121]

Consolidate LATAs in Minnesota and Arizona, 14 FCC Rcd 14392 at ¶¶ 17-18 (1999) (hereinafter "*InterLATA Boundary Order*").

118 *See* 47 U.S.C. § 252(d)(1); 47 U.S.C. § 252(c)(2).

119 *Triennial Review Order*, 18 FCC Rcd at 17386, ¶ 657 (emphasis added).

120 *See* Gillan (CALTEL) Ex. 131, pp. 34-35.

121 *See* Gillan (CALTEL) Ex. 131, p. 41.

The FCC has stated, however, that facilities required only under section 271 are not subject to the TELRIC-based rates that apply under section 251. Rather, an element that is required only under section 271 is subject to the "basic just, reasonable, and nondiscriminatory rate standard of sections 201 and 202" of the Communications Act.[122] The FCC has further held that, under sections 201 and 202, "the market price should prevail" – "as opposed to a regulated rate" of the type that CALTEL would have this Commission impose.[123]

Thus, a Bell Operating Company may satisfy sections 201 and 202 by, among other things, "demonstrating that the rate for a section 271 network element is at or below the rate at which the BOC offers [any] comparable functions" under its federal tariffs, or "by showing that it has entered into arms-length agreements with other, similarly situated purchasing carriers to provide the element at that rate."[124] The D.C. Circuit affirmed the FCC on this point, explaining that there is "no serious argument" that the pricing requirements that apply to section 251 elements also apply to section 271, and that there was "nothing unreasonable in the [FCC's] decision to confine TELRIC pricing to instances where it has found impairment" under section 251."[125]

Applicants argue that CALTEL would have this Commission mandate a regulated price based on the TELRIC-based rate that the FCC has held is

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[122] *Triennial Review Order*, 18 FCC Rcd at 17389, ¶ 663.

[123] *UNE Remand Order,* 15 FCC Rcd at 3906, ¶ 473.

[124] *Triennial Review Order*, 18 FCC Rcd at 17389, ¶ 664.

[125] *USTA II*, 359 F.3d at 589.

available solely for the CLECs' "embedded base" of customers (and only for as long as necessary to effectuate the prompt transition mandated by the FCC's order), and then reduce that price from there. Applicants claim that approach would subvert the market-based mechanism for establishing rates contemplated by the FCC.

b) Discussion

We agree with CALTEL that the merger will increase the imbalance of resources between SBC and its competitors as a result of the acquisition of AT&T.

We do not agree with CALTEL, however, that its proposal for price caps on all network elements to be made available through Section 251 and 271 is an appropriate remedy to address this imbalance. As noted by Applicants, a price cap would be at odds with the broader market-based pricing policies that the FCC has adopted through the TRRO, at least for those UNEs offered under Section 251 for which TELRIC pricing has been eliminated. Capping the rates in the manner proposed by CALTEL for such UNEs would undermine the TRRO policy to phase out TELRIC-based pricing of such UNEs provisioned under Section 251. On the other hand, for those UNEs for which TELRIC-based pricing was not eliminated by the TRRO, we conclude that the CALTEL price cap proposal is an appropriate remedy. Accordingly,we shall adopt CALTEL's price cap proposal for those UNEs to be provided under Sec. 251 only to the extent that, pursuant to the TRRO, the FCC has not eliminated TELRIC-based pricing for it. We agree with Applicants, however, that in order to be consistent with TELRIC principles, the rate caps should not be reduced for a productivity factor. Accordingly, we shall adopt the rate caps for applicable network elements with no productivity offset.

We further conclude that Commission-imposed price caps on those UNEs provisioned under Section 271 could conflict with broader FCC "just-and-reasonable" principles relating to the pricing of such UNEs. Although we decline to impose price caps for such UNEs, as noted, we will adopt other mitigating remedies to address the resource imbalance, as discussed below.

CALTEL also contends that SBC California can be required to combine, or "commingle," facilities that must be made available pursuant to section 271.[126] The FCC, however, has held that, where an element is required under section 271 but not under section 251, the BOC is under no obligation "to combine" that element with others.[127] Although the *Triennial Review Order* originally listed section 271 elements in the context of commingling obligations in paragraph 584, the FCC subsequently removed this reference, thus confirming that commingling obligations do not extend to section 271 elements.[128] Accordingly, the New York Public Service Commission recently concluded, "[g]iven the FCC's decision to not require BOCs to combine 271 elements no longer required to be unbundled under section 251, it seems clear that there is no federal right to 271-based UNE-

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[126] *See* Gillan (CALTEL) Ex. 131, pp. 25-27. "Commingling" means the connecting, attaching, or otherwise linking of a UNE, or UNE combination, to one or more facilities or services that a requesting carrier has obtained at wholesale from an incumbent LEC pursuant to any method other than unbundling under Sec. 251(c)(3) of the Act, or the combining of a UNE or UNE combination with one or more such wholesale services.

[127] *See Triennial Review Order*, 18 FCC Rcd at 17386, ¶ 655 n.1990; *see also United States Telecom Ass'n*, 359 F.3d at 589-90 (affirming FCC's no-combinations holding).

[128] *See* Errata, *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 FCC Rcd 19020, ¶ 27 (2003).

[Platform] arrangements."[129] Applicants argue that for this reason as well, CALTEL's proposals to require commingling is contrary to federal law.

We agree with Applicants that based on the TRO errata, the FCC does not require BOCs to commingle Sec. 271 facilities.

2. Proposal for "Opt-In" Rules

a) Parties' Positions

CALTEL witness Gillan argues that his proposed price cap plan, by itself, however, will not fully dilute the resource leverage gained by SBC if the proposed merger were to be approved without conditions. SBC will still have the opportunity to increase its rival's costs through serial arbitrations that re-litigate the same issue. To address this concern, Gillan proposes that SBC be required to follow certain interconnection agreement "opt-in" rules to avoid duplicative, unnecessary arbitrations.

Where, in the past, CLECs frequently could wait until AT&T (or MCI) had arbitrated an agreement and then "opt-in" to gain the benefit of those carrier's arbitration efforts, that "litigation umbrella" would be eliminated with the consummation of the planned mergers, eliminating AT&T and MCI as independent litigation counterweights to SBC. Gillan argues that the general resource imbalance further advantages SBC because the costs of arbitration (per customer) for a CLEC would far exceed its own. As a result, any express or implicit strategy by SBC that creates unnecessary litigation and/or arbitration costs would harm competitors far more than SBC.

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[129] Order Implementing TRRO Changes, Case No. 05-C-0203, at 22 (N.Y. PSC Mar. 16, 2005). *See also* Arbitration Decision, Docket No. 04-0371, at 18 (Illinois Commerce Comm'n Sept. 9, 2004).

To mitigate this adverse impact, Gillan proposes that except for state-specific prices and performance standards, SBC be required to allow any CLEC to adopt in California any agreement that SBC has negotiated in any other state; or any provision (or set of interrelated provisions) that SBC has included in an agreement as the result of arbitration in California.

Gillan patterns this recommendation after conditions applied to SBC and Bell Atlantic when they acquired Ameritech and GTE respectively, adjusted to reflect what he views as the greater threat to the bilateral negotiation/arbitration process presented by this merger. When SBC acquired Ameritech, it agreed to import any interconnection *arrangement* that it negotiated in another state, and did not require that the CLEC import the entire *agreement*. Gillan's recommendation in this proceeding is different because underlying federal opt-in rules have become more restrictive in that they now require CLECs to adopt an entire agreement, instead of individual parts.[130]

Gillan also recommends that SBC be required to agree to include in any interconnection agreement any *provision* that was already arbitrated by the California Commission. This recommendation is intended to limit SBC's incentive to increase its competitor's costs in California by engaging in serial arbitration on the same issue. Gillan argues that the potential gains to SBC from serial litigation will increase as a result of this merger being approved. The *behavior* that these recommendations address – that is, arbitrating the same issue multiple times – is at odds with federal policy. Given the resource imbalance

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[130] Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, WC Docket 01-338, Second Report and Order, 19 FCC Rcd 13494, FCC 04-164, (rel. July 13, 2004) ("All or Nothing Order").

that will be created by the proposed merger, Gillan characterizes his proposal as a mitigating measure to prevent competitive harm.

Applicants object to this condition, arguing that it does not address any issue directly related to the merger, or any adverse consequence therefrom. Applicants argue that carriers do not need this condition in order for there to be fair competition.

b) Discussion

We adopt CALTEL's proposal to require SBC to follow "opt-in" rules. Particularly because we are not adopting most of CALTEL's price caps proposal for network elements under Section 251 and 271, we believe that competitors require the additional offsetting remedy of being able to opt in to any agreement negotiated in any other state, or any provision of any agreement in California. Gillan's proposal is consistent with federal rules by ensuring that SBC not leverage its resource advantage against CLECs in a more cost effective way than threatening SBC with enforcement action. Gillan argues that such action itself would increase CLEC costs and only apply after SBC had already increased costs in the first instance through serial arbitration.

SBC will not be required to import into California any arbitrated decision by any other Commission, but only any interconnection agreement provisions already ruled upon by <u>this</u> Commission. For agreements that SBC negotiated in other states, it would have to permit California CLECs the opportunity to adopt those agreements (except as to price and state-specific performance measures), but the CLECs would be required to adopt the entire agreement.

3. Mitigation Measures for Special Access

Multiple parties proposed that mitigation measures be imposed as a result of alleged effects of the merger on the market for local and intermediate distance transport services, also known as "special access." Special access services consist of dedicated digital facilities connecting individual (typically enterprise) customer premises with the serving SBC wire center ("channel terminals") and interconnecting the special access channel terminals with a CLEC or interexchange carrier point of presence ("interoffice transport"). Special access is the enterprise service equivalent of the "local loop" that connects a residential or small business customer to the local SBC wire center. These are "essential facilities" without which the competing local or interexchange carrier could not deliver its services to its end user enterprise customers. (ORA Opening Brief, page 55). Special access is critical to allow facilities-based competitors to provide both local and nonlocal services to California customers. (Qwest Brief, page 22.)

a) Parties' Positions

Level 3 witness Vidal testified that the special access market is highly concentrated with few companies owning the physical local networks required for connecting "long-haul" or "backbone" networks to customers' buildings or traffic aggregation points such as carrier hotels and RBOC central offices. ILECs, like SBC, are the dominant suppliers of transport services within their traditional service areas. AT&T and MCI are the largest nondominant carriers offering competitive access. Carriers express concern that, with the disappearance of AT&T and MCI, there will be no competitive alternatives from which to purchase these services. Without sufficient traffic volume, it may not be cost-effective for a competing carrier to build its own connecting networks in metropolitan and suburban areas. The next option available to such carriers would be to lease transport. It is common that the only facilities-based providers of transport from which to enter into a lease will be either SBC or AT&T.

ORA witness Selwyn testified that: "SBC is the *only* source of special access services to every customer location throughout the SBC footprint. As such, SBC has unique opportunities not available to other competitors." (Ex. 126/126-C, p.161, ORA/Selwyn.) ORA argues that AT&T has up to now been one of the strongest – if not *the* strongest – competitor to SBC in this sector. In 2002, AT&T had estimated that "of the approximately three million commercial/business customer locations nationwide, it was providing service to approximately 186,000 of these locations using some type of special access service or its equivalent. Of these, only about 6,000 locations were being served directly using AT&T-owned dedicated access facilities, another 3,700 were being served using dedicated access facilities being leased from other CLCs, and the remaining 176,300 were being served by ILEC special access services." (*Id.*, at 171, footnotes omitted.)

ORA claims that AT&T's departure from the special access market – and the absorption of its fiber optic "last mile" facilities into the SBC asset base – will further strengthen SBC's market power over these essential services and facilities.

Level 3 argues that eliminating AT&T as the sole alternative provider of special access will make it unnecessarily expensive for competing carriers to reach Tier II and Tier III markets.

Level 3 argues that conditions should be imposed to ensure that special access prices are reasonable and nondiscriminatory. Qwest also submitted testimony claiming that the removal of AT&T and MCI from the market will diminish or, in some cases, possibly eliminate, the pricing pressure currently exerted on SBC's special access rates. Qwest argues that "AT&T and MCI exert pressure on SBC's pricing where they have alternative facilities that allow a consumer to bypass SBC's facilities."[131] Level 3 similarly claims that "[i]n many instances, the only competition for SBC for competitive access is AT&T . . . [and] unless regulators take the appropriate steps, a carrier such as Level 3 will not have any competitive alternative from which to purchase services."[132] SBC has discounted special access offerings under tariff which are available only to the largest carriers.[133] AT&T has been a major customer of these special offerings, and has served as a competitive balance to SBC by in turn reselling these offerings to others,[134] tending to hold SBC's prices in relative check in the special access market. Level 3 argues that the competitive check provided by AT&T is critical to smaller competitors who do not qualify for the SBC national discount tariffs.[135] Level 3 argues, in addition, that barriers to entry would prevent it from developing its own facilities to replace the special access services lost by AT&T's departure from the market.[136]

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131 Stegora Axberg (Qwest) Ex. 119, p. 12.

132 Vidal (Level 3) Ex. 13, p. 11.

133 Exhibits 10, 11, 76, 77.

134 AT&T claims that it buys from SBC most of the special access which it uses in California, in part because other CLECs have so little to offer in the way of special access facilities. Tr. Vol. 8, pp. 1107-1108, AT&T Giovannucci. Therefore, both AT&T and the other CLECs which buy special access through it depend on AT&T's special access tariff pricing for which the other CLECs do not qualify. See Exh. 10 and 11 and Tr. Vol. 8, pp. 1113-1121, AT&T Giovannucci.

135 Axberg Reply Testimony, Qwest Exh. 119, pp. 12-14.

136 Vidal (Level 3) Ex. 13, p. 11.

Qwest and other competitors contend that AT&T has threatened to use its own facilities if it is unable to obtain favorable terms from SBC. Applicants respond that any significant purchaser of access services from SBC (or any other ILEC) can make the same threat, and the abundance of competitive fiber demonstrates that this threat is real. Level 3 contends that AT&T "has served as a competitive balance to SBC by in turn re-selling these offerings to others."[137]

Similar to Level 3, Qwest asserts that AT&T "is actually engaged in providing wholesale access services in competition with SBC."[138] But Mr. Giovannucci testified that AT&T is only a bit player in offering wholesale special access.[139]

Applicants argue that AT&T has no impact on SBC's special access pricing because it is not a competitor or constraining force on SBC's special access pricing.

Applicants further argue that the merger will have no effect on the current level of CLECs' competitive special access options, and that CLECs purchase virtually no private line services from AT&T. Applicants claim that AT&T has few commercial buildings directly connected to its own fiber facilities. Applicants argue that even those buildings are so specialized for specific customers as to be irrelevant in the special access market.[140] Applicants claim

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137 Level 3 Opening Brief, p. 24.

138 Qwest Opening Brief, p. 25.

139 *See* JAs Opening Brief, pp. 84-87

140 Giovannucci (JAs) 8 Tr. 1052.

that CLECs can still obtain special access service using ILEC special access as the local transport vehicle and win customers after the merger.[141]

Witness Giovanucci testified that AT&T has a retail focus and uses its local network primarily to serve its retail customers. Giovanucci stated that AT&T's 'fiber-to-the-floor' (FTTF) (*i.e.*, fiber directly to the customer's proprietary area on its premise) building architecture used to serve the vast majority of its on-net buildings is not conducive to the widespread sale of wholesale services.[142]

Giovannucci testified that AT&T is not a major wholesale provider, with fiber connections to very few buildings where it does have customers and an even smaller percentage where it doesn't.[143]

AT&T only builds out to a new building when it sells retail service to a large enterprise customer.[144] When AT&T builds out to the new customer, it deploys its fiber and electronics directly to the customer's offices in the customer-provided space. As a consequence, Applicants argue that AT&T is in no position to sell wholesale special access service to other CLECs, but frequently purchases its own special access from another carrier to serve other enterprise customers in the same building.

Qwest also disputes Applicants' claim that AT&T is almost exclusively a long-haul carrier with almost no local facilities, and with almost no facilities overlap with SBC. Qwest points to statements made by AT&T in its March 15,

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141 Giovannucci (JAs) 8 Tr. 1057.

142 Giovannucci (JAs) Ex. 2, pp. 2-3.

143 Giovannucci (JAs) 8 Tr. 1105.

144 Giovannucci (JAs) Ex. 2, p. 2.

2004 Form 10-K Report to the effect that AT&T has "an extensive local network serving business customers" and provides "a broad range of …wholesale transport services."[145] As additional evidence of AT&T's local facilities presence, Qwest points to AT&T's purchase of TCG in 1998, a competitive access provider that served over 20,000 buildings over 11,417 route miles of fiber.[146]

Qwest points out, however, because SBC has a ubiquitous network, SBC necessarily serves the same customer premises as does AT&T, and SBC's special access facilities will overlap with those of AT&T after the merger. If AT&T's facilities are removed, SBC's network is already built to the same customer premise.

Applicants argue that Qwest (and other CLECs) can and do negotiate with SBC to encourage SBC to offer special access pricing that they would like to see in the market place. Applicants deny that AT&T has any unique influence over SBC's special access pricing today, arguing that the rates that SBC and AT&T negotiated were filed by SBC in tariff form and are thus "available to all carriers."[147] Applicants argue that even if AT&T is no longer negotiating for better prices, the Commission cannot assume that remaining competitors will not negotiate as aggressively and effectively to obtain favorable rates, terms and conditions.

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145 Ex. 66 (AT&T Form 10-K).

146 AG Opinion at 24

147 Qwest Opening Brief, p. 27.

b) Mitigating Conditions

We agree that the evidence shows that the merger will increase SBC's market power in the pricing of special access. AT&T's network witness Giovannuci admitted that following the merger, the continued availability of special access service from AT&T will be important for CLEC customers who currently purchase special access service from AT&T.[148] SBC, according to this witness, has market power in special access in California.[149] The removal of AT&T as a competitor and a prime discount reseller of SBC's large customer special access would give SBC additional opportunities to leverage its market power against CLEC competitors to the disadvantage of consumers.[150] Qwest argues that AT&T has been pivotal in disciplining the rates, terms, and conditions under which SBC offers interstate special access, both as an alternative source of supply and by its negotiating leverage through which it has obtained more favorable rate discounts, terms, and conditions as set forth in SBC's federal tariffs. Qwest claims that AT&T is uniquely positioned to negotiate favorable terms, citing internal documents about SBC's tariff,[151] out of which Qwest itself buys service.[152]

The concessions obtained by AT&T and MCI then become available to other carriers such as Qwest through the general applicability of SBC's tariff

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[148] Tr. Vol. 8, p. 1134, AT&T Giovannucci.

[149] Tr. Vol. 8, pp. 1147-1148, AT&T Giovannucci.

[150] Reply Testimony of Dr. Lee Selwyn, Exh. 126, pp. 152-156, 159-182.

[151] Qwest Opening Brief, pp. 27-32.

[152] Qwest Opening Brief, p. 21.

offerings. With the elimination of both AT&T and MCI as a discipline in the negotiation process, the rate discounts, terms, and conditions currently available in SBC's tariffed plans could disappear, not necessarily immediately, but over time.

Accordingly, we consider the mitigating conditions that have been proposed. To mitigate these concerns relating to SBC's increased market power over special access, Qwest and Level 3 thus ask the Commission to impose the following conditions:

- Require SBC to offer all customers intrastate and interstate special access at the lowest rates currently offered by either SBC or AT&T.
- Prohibit SBC from giving AT&T or Verizon/MCI better special access terms and conditions than those offered to others.
- Require SBC to offer competitors in California any services or facilities the post-merger entity purchases from other ILECs out-of-region at the same rates, terms and conditions the post-merger entity obtains from ILECs out-of-region.
- Require SBC to give its wholesale customers a "fresh look" right to terminate their contracts without incurring termination liability.
- Require public disclosure of all special access contracts between SBC and AT&T and its affiliates and to permit competitors to accept individual terms from these agreements without being required to accept all the terms.

Applicants object to the special access pricing mitigation measures. To the extent these proposed measures involve *interstate* special services, Applicants argue that such regulation is not within the jurisdiction of this Commission.

Applicants also claim that none of the complaints raised by Qwest and Level 3 is specific to California, and thus bear no relation to "adverse consequences" under § 854.

Applicants further argue that a series of FCC proceedings will address special access services and competitive issues, including pricing, provisioning and discrimination, and market power at the wholesale level. Applicants argue that the FCC, not this Commission, is best positioned to deal with special access issues arising out of this merger. Applicants thus propose that this issue be deferred to the FCC.

As previously discussed above, we are obligated to consider the full range of competitive impacts even though federal authorities may also independently be reviewing them.

(1) Equal Access to Terms and Conditions

Level 3 proposes a requirement that any transactions between SBC and AT&T and other affiliates be negotiated at arms length and disclosed publicly. Level 3 also proposes that combined entity be required to offer the individual negotiated terms on a stand-alone basis without requiring an entity to adopt all of the terms and conditions of a contract.

We shall require public disclosure of transactions between SBC and AT&T. We will not approve of the Level 3 proposal to permit carriers to pick and choose individual terms, but we shall require that carriers be allowed to obtain the same complete package of terms and conditions.

(2) Access to Lowest Currently Available Rate

Qwest proposes that SBC be required to offer special access in California at the lowest rate currently available either from SBC or AT&T, and to keep those rates in place for a fixed period of time. Qwest further proposes that SBC should be required to offer special access and other services at the same rates, terms, and conditions that it receives when it purchases equivalent services outside the SBC region. We shall require SBC to make available to carriers the lowest rate available from SBC or AT&T to remain in place for a 5-year period. We shall impose a similar requirement for special access that SBC purchases out of region. Qwest argues that such a condition would allow the leverage exerted by the merged company in its out-of-region markets to serve as a proxy for the same or equivalent services in California where AT&T no longer would exert pressure to drive lower rates.

(3) Fresh Look Opportunity

Both Qwest and Level 3 further propose a "fresh-look" period following the closing of the merger for entities to terminate their contracts with AT&T without incurring any termination liability, to permit such entities to take advantage of any improved terms that SBC offers its affiliates.

Applicants argue that such "fresh look" provisions are contrary to law under the TRO. Qwest disagree, arguing that in the portions of the TRO cited by Applicants, the FCC was merely addressing whether a fresh look opportunity should be afforded to CLECs when transitioning from special access to UNEs.[153] Because a different context is at issue here, namely, conditions on approval of a merger, Qwest argues that there is no FCC prohibition against imposing a "fresh look" condition here.

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[153] TRO at Parg. 693

We agree that the TRO does not specifically address the "fresh look" applicability in the context of reviewing and placing conditions on approval of a merger. Nonetheless, the FCC does set forth the general principle that the grant of a "fresh look" is "a very rare occurrence."[154] Thus, we conclude that a particularly extreme and specific harm would need to be shown in order to justify granting such a condition here. We shall permit a fresh look condition for the limited purpose of accepting the complete package of terms and rates that was negotiated between SBC affiliates. We do not find that the parties have made a sufficient showing here that a "fresh look" requirement is necessary for any other purpose in order to avoid an anticompetitive result from the merger, particularly in view of the other mitigating conditions we are adopting. Accordingly, we decline to adopt the "fresh look" as a condition of the merger, with the limited exception as noted.

4. Capping of Special Access Rates

In his Advisory Opinion issued in this proceeding, the AG proposes, as a mitigating measure, that "the Commission freeze for one year rates paid by current AT&T customers receiving DS1 or DS3 private network service."[155] The Attorney General proposes this condition to mitigate the concern that "the merger may enable SBC to raise the average rates paid for DS1 and DS3 private network services."[156] The FCC stated that where a building generates more than two DS3's of demand, a CLEC will have sufficient incentive and economic ability

[154] TRO at Parg. 694

[155] Attorney General's Opinion, p. 27.

[156] Attorney General's Opinion, p. 23.

to provision its own access.[157] The AG notes in his Opinion that 58% of the buildings served in the four MSAs in which AT&T and SBC provide "overlapping" special access services have bandwidth requirements of two DS3s or greater.[158] The AG limited the duration of the proposed condition to one year so that "the relatively brief span of the transition period would minimize the distortions and disincentives resulting from the rate freeze."[159]

CALTEL proposes that the Commission cap intrastate special access rates of SBC for a period of five years in order to limit SBC's ability to leverage its acquisition of AT&T in order to increase special access rates to higher levels. CALTEL also proposes that the Commission make a direct recommendation to the FCC that it cap SBC's interstate special access rates for a similar time.

We shall adopt a rate freeze on intrastate special access rates for both SBC and AT&T. We conclude, however, that limiting the rate freeze to only a one-year period is too short to serve as an effective mitigation tool. Consistent with the timeframe we have adopted for other mitigation measures, we shall require that the rate freeze last for a five-year period. The rate freeze will serve as a mitigation against excessive rate increases. We also believe that the FCC should take similar action to freeze interstate special access.

As noted above, we conclude that a period of 5 years should apply, during which carriers can obtain the lowest available rate both for SBC and AT&T special access rates.

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[157] *TRRO*, ¶ 154, 177.

[158] Attorney General's Opinion, p. 12.

[159] Attorney General's Opinion, p. 27.

5. Internet Peering Arrangements

a) Parties' Positions

SBC currently provides high-speed Internet access via its ADSL offering to more than 50% of California high-speed Internet service customers, but is not a Tier 1 Internet backbone carrier. SBC must therefore purchase access to the Internet backbone from nonaffiliated providers. AT&T, on the other hand, is a Tier 1 Internet backbone provider but, because it has no mass market local "last mile" facilities, is not a consequential player in the mass market high-speed Internet service market. There is no existing firm that offers both retail high-speed Internet access in the mass market and that is also a Tier 1 Internet backbone provider. Tier 1 internet backbone providers do not have to pay for transit due to peering arrangements with other Tier 1 providers.

When joined with AT&T, SBC will become both the largest provider of consumer high-speed Internet access services in California and a Tier 1 internet backbone carrier. By virtue of its Tier 1 status, SBC will be able to exchange traffic with other Tier 1 internet providers without paying for bandwidth. ORA witness Selwyn testified that this cost-free access to the Internet backbone will give SBC a cost advantage that no other high-speed internet service providers will be able to match. (Ex. 126C, pp. 156-158, ORA/Selwyn.)

Today there are six "Tier 1" Internet backbone providers (i.e., AT&T, MCI, Sprint, Level 3, Qwest and Global Crossing) that other carriers must pay for Internet transit. These carriers are able to charge other providers of Internet services because they alone interconnect with all other Internet backbones.

Currently, as a non-Tier 1 participant, SBC has agreed to peering arrangements with other non-Tier 1 providers (such as Cox) for the exchange of traffic on a settlement free basis. These arrangements exist among non-Tier 1 carriers because of the mutual benefit of peering. Once SBC acquires AT&T, however, it will (presumably) attain Tier 1 status and will no longer have the incentive to exchange traffic without fees.

SBC hopes to integrate its Internet Protocol (IP) network with that of AT&T to obtain greater network synergies.[160] Witness Gillan argues that these network gains, however, should not be used an excuse to "de-peer" other Internet providers with whom SBC exchanges IP traffic presently. Gillan thus recommends that SBC be required to honor all existing Internet peering arrangements and to offer extensions (if requested by the carrier) for an additional five-years at existing terms, conditions and prices.

Applicants also dismiss the claims that competitors will be adversely impacted by SBC's integration with AT&T's IP backbone. Applicants argue that this market segment is even less concentrated today than when the FCC approved the divestiture of MCI's Internet backbone facilities to the merging owners of the two top backbone providers, finding that Internet services were "competitive, accessible, and devoid of entry barriers."[161] Applicants further argue that the protestants do not explain how and why "many Internet Service Providers (ISPs) successfully competed against MCI and other vertically integrated firms when the market was considerably more concentrated than it is

[160] *See*, for instance, Rice Declaration, Federal Communications Commission Docket WC Docket No. 05-65, February 21, 2005.

[161] *In re Application of WorldCom, Inc. and MCI Communications Corp. for Transfer of Control of MCI Communications Corp. to WorldCom, Inc.*, Memorandum Opinion and Order, 13 FCC Rcd. 18,025, ¶ 142 (1998).

today."[162] Based on their claim that there is more competition today for these services than ever before, Applicants discount protestants' claims that SBC's integration with AT&T will result in any detriment to competition.

b) Discussion

We conclude that the merger will increase SBC's market power through the combination of becoming a Tier 1 Internet backbone carrier and being the largest provider of consumer high-speed Internet access in California. The merger will provide SBC both the incentive and the opportunity to engage in discriminatory treatment of nonaffiliated rivals, both with respect to upstream backbone services and downstream retail services. (Ex. 126, p. 83, ORA/Selwyn). We shall therefore adopt the proposal that, as a condition of finding that the merger is not anticompetitive, SBC agree to honor all of its existing Internet peering arrangements and to offer extensions, if requested by the carrier, at existing terms, conditions, and prices. This condition shall remain in effect for a five-year period from the effective date of this decision.

We find Applicants' argument unpersuasive that carriers such as Cox can switch to another Tier I provider. Gillan's testimony focuses on the peering agreement between Cox and SBC, both of which are ***non-Tier 1 providers***. Cox cannot simply switch to either another non-Tier 1 provider or a Tier 1 provider without adverse consequence. If SBC were to de-peer Cox, it would have to pay transit fees on traffic that it is currently exchanging with SBC on settlement free basis.[163]

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[162] Attorney General's Opinion, pp. 28-29.

[163] Exh. 116, p. 14.

Applicants also argue that the FCC has concluded that Internet services are competitive so that Cox can choose another Tier 1 provider,[164] and that ISPs can compete with vertically integrated firms.[165] Yet, Cox's proposed condition does not address "Internet services," but rather the relationship between the parties providing the underlying telecommunications. Arguments about ISPs competing with SBC and/or AT&T are not relevant to Cox's proposed condition. The proposed condition is not directed towards any consequences that the merger may have on ISPs, but addresses the concern that the merger would increase SBC's incentive and ability to engage in anticompetitive behavior towards other carriers.

Likewise, while Internet services are "subject to federal oversight and beyond the Commission's jurisdiction," Cox's proposed measure does not involve regulation of "the Internet." It addresses carriers' networks and underlying interconnection arrangements. Moreover, the Commission has authority to impose conditions pursuant to § 854 notwithstanding the fact that federally regulated services may be implicated, as previously discussed. We accordingly adopt the condition as noted above.

6. Transit Service at Cost-Based Rates

a) Parties' Positions

Gillan also proposes that SBC be required to offer transit services at cost-based TELRIC rates. Gillan claims that transit services are essential to competitive local exchange carriers (LECs) and wireless providers that cannot

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164 JA Brief, p. 66.

165 *Id.*

interconnect with all other carriers directly. Even a company like Cox, which has more than 100 interconnection agreements nationwide with non-incumbents, depends on transit service to reach most other carriers.

This merger will further increase the scale efficiency of the SBC exchange network. SBC has had an opportunity to gradually deploy network facilities in its role as the largest California ILEC and is the central network to which all other providers must interconnect. Gillan argues that the existing exchange network should facilitate new network deployment by enabling a network-of-networks to evolve in the most efficient manner.

Transit traffic arrangements are used routinely by LECs to allow their customers to complete calls to each other's customers. "Meet Point Billing" arrangements represent the standard methodology of the telecommunications industry governing how interexchange traffic is exchanged and how each carrier will bill other carriers for its part in carrying it. With the enactment of the Federal Act and the introduction of local competition, CLECs require transit for local traffic as well. CLECs also require the ability to efficiently interconnect with wireless networks and the networks of interexchange carriers.

Gillan proposes that as a condition of the merger, SBC not be permitted to charge transit rates to CLECs above cost. This condition will avoid creating an incentive for carriers to establish direct connections before it is efficient to do so. Section 251(c)(2)(A) requires incumbents to interconnect their networks with those of requesting carriers "for the transmission and routing of telephone exchange service and exchange access."[166] Nothing in this obligation limits a

[166] 47 U.S.C. § 251(c)(2). (Emphasis added).

requesting carrier to interconnection with the incumbent to route traffic only to and from the incumbent's customers. Transit is as much a part of the "transmission and routing of telephone exchange service and exchange access" as other forms of interconnection.[167]

It is unclear exactly how the post-merger environment will stabilize, and which carriers will have the traffic flows to justify dedicated connections once a new equilibrium is reached.[168] Gillan believes the best "transit policy" in response to this situation is to require SBC to offer the service at cost-based rates, with individual carriers deciding the point at which dedicated connections are the more efficient alternative. If the Commission adopts some limitation, however, then Gillan recommends using a proxy for the basic economic choice of traffic volumes sufficient to justify a dedicated connection. For instance, he suggests that a possible limitation that transit at TELRIC rates not be available when two providers are exchanging traffic at the level equivalent to what would

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[167] Likewise, nothing in the definitions of "telephone exchange service" and "exchange access" limits those terms to exclude transit traffic. Section 153(47) of the Act defines "telephone exchange service" as: "(A) service within a telephone exchange, or within a connected system of telephone exchanges within the same exchange area operated to furnish to subscribers intercommunicating service of the character ordinarily furnished by a single exchange, and which is covered by the exchange service charge or (B) comparable service provided through a system of switches, transmission equipment, or other facilities (or combination thereof) by which a subscriber can originate and terminate a telecommunications service." 47 U.S.C. 153(47). Section 153(16) of the Act defines "exchange access" as: "the offering of access to telephone exchange services or facilities for the purpose of the origination or termination of telephone toll services." 47 U.S.C. 153(16) (2002).

[168] For instance, consider the wasted cost that a CLEC would have incurred had it reconfigured its network to "avoid SBC" by connecting directly with "AT&T."

be carried by ten DS-1s for three consecutive months.[169] If this transit threshold is exceeded, then SBC could charge higher than TELRIC rates for the transit traffic. In any case, Gillan argues that the interconnecting carriers must be allowed a reasonable period of time (e.g., he suggests six months) to engineer and install direct interconnection, and traffic exchanged indirectly via SBC transit services should remain at TELRIC rates to the degree that the amount of transit traffic falls below the threshold used to trigger direct interconnection.

Applicants oppose this condition, arguing that it does not address any issue or adverse consequence directly related to the merger that requires mitigation. Applicants claim the market will be competitive without this condition.

We find this condition reasonable for the reasons discussed above, and hereby adopt it. We conclude that this condition reasonably addresses the adverse consequences that may result from the inevitable change in traffic flows resulting from the integration of the SBC and AT&T network facilities by providing a degree of stability and certainty to carriers with respect to transit rates. It is unclear how the post-merger environment will stabilize with respect to identifying which carriers will have the traffic flows to justify dedicated

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[169] When engineering a new direct interconnection between LECs, carriers generally build or obtain an efficient transmission vehicle, such as DS-3 over fiber optic cable, for such purpose. Depending on its source, the cost of a single DS-3 connection is typically equivalent to the cost of between eight and twelve individual DS-1s. The use of ten DS-1s as a triggering mechanism represents a point where deployment of direct interoffice facilities between two LECs makes economic sense. In prior interconnection agreement arbitrations, the Commission has required parties to include provisions on their interconnection agreements that state a CLEC will seek to establish direct connection with third parties when the traffic level reaches three DS1 level for three consecutive months

connections once a new equilibrium is reached. Imposing this condition will promote competitive stability in traffic flows as the industry adjusts to the effects of the merger. We shall set require that this condition continue in place for a five-year period from the effective date of this decision. This time frame is consistent with the related conditions we are adopting for the extension of existing transport agreements.

7. Extension of Transport Agreements

Witness Gillan also proposes a requirement that AT&T extend existing transport agreements for five years at the same rates, terms and conditions to mitigate the elimination of AT&T as a competitor in the short-haul transport market. SBC and AT&T compete in the short-haul transport market in California, and AT&T is the only alternative provider to SBC on some routes. AT&T has an extensive transport network. Cox has transport agreements with AT&T on certain routes that only AT&T and SBC serve.[170] As the only competitor to SBC on at least certain routes, AT&T provides pricing discipline in the short-haul transport market. Once the merger is implemented, AT&T will no longer be a competitor to SBC and this will adversely affect competition in this market segment. Gillan testified that AT&T's pre-merger incentive to facilitate competitive entry is quite different than the incentives of the merged firm in that AT&T had little retail share to try and "protect" by increasing the costs of competitors. It had no incentive to help protect SBC's share. Gillan claims that the combined firm, however, cannot be expected to welcome the same competitive activity. Gillan thus recommends that SBC be required to offer to

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[170] Exh. 116, p. 15.

automatically extend, for a five-year period, any transport contracts between AT&T and another carrier for capacity at DS3 or greater. Applicants object to this condition, arguing that it does not address any issue directly related to the merger, or any adverse consequence therefrom. Applicants argue that carriers do not need this condition in order for there to be fair competition. We agree that requiring SBC/AT&T to maintain and extend existing transport agreements for a five-year period directly relates to the resulting consequence and hereby adopt this proposed condition. Adopting this condition will promote price stability in response to SBC eliminating its only competitor.

8. Rates Paid for Exchange of VoIP Traffic

Level 3 proposes that, as a condition of approving the merger, that SBC be required to exchange all VoIP traffic—defined as locally dialed calls where one end of the call originates or terminates on the Internet—at the local reciprocal compensation rate. Level 3 argues that, by doing so, the Commission will ensure that VoIP customers will be on the same footing as traditional telephone customers when making local calls, and that the underlying networks will be compensated for the use of their networks.[171]

Without this restriction, Level 3 argues that the combined entity will have excessive market power over ESP services, especially Voice Over IP, by applying higher rates such as access charges for calls that leave the SBC network.

In addition, in order to ensure that there is no discriminatory pricing between AT&T and SBC with respect to VoIP services, Level 3 argues that such transactions must be conducted at arms length, publicly disclosed and the prices

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[171] Reply Testimony of Ron Vidal, Level 3, Exh. 13, pp. 27-28.

in that agreement offered to all other providers without regard for any volume or term discounts.[172]

Applicants object to this condition, arguing that it does not address any issue directly related to the merger, or any adverse consequence therefrom. Applicants argue that carriers do not need this condition in order for there to be fair competition.

We decline to adopt the proposed pricing restriction calling for the exchange of VoIP traffic at reciprocal compensation rates. Level 3 has not adequately justified that this sort of Commission intervention is warranted for into VoIP calls that originate or terminate on the Internet. We agree, however, that to ensure there is no discriminatory pricing, transactions between AT&T and SBC with respect to VoIP services shall be conducted at arms length and publicly disclosed, with similar prices, terms, and conditions offered to other carriers on a nondiscriminatory basis.

9. Access to Numbering Resources

Level 3 proposes that the combined entity be required to immediately return any unused 1000-number or 10,000-number blocks, and to assign numbers across the combined entity from the available inventory of the individual companies. Level 3 proposes that, going forward, SBC should seek additional numbering resources only as one entity and only when the appropriate number utilization thresholds are met as one entity.

Applicants object to this condition, arguing that it does not address any issue directly related to the merger, or any adverse consequence therefrom.

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[172] Reply Testimony of Ron Vidal, Level 3, Exh. 13, p. 28.

Applicants argue that carriers do not need this condition in order for there to be fair competition.

We agree with Level 3 with respect to this condition. Applying number resource allocation rules to SBC and AT&T combined operations as a single entity will enhance the efficient utilization of number resources consistent with Commission policy.

10. Stand-Alone DSL

SBC bundles DSL with its wireline service and does not offer a stand-alone DSL product.[173] Stand-alone DSL refers to the offering of DSL, for high speed Internet access, to a customer without also requiring the customer to buy additional services, such as traditional local phone service or VoIP service, from the same provider.

ORA, Qwest, and Level 3 propose that as a condition of approving the merger, stand-alone DSL be provided by the merging entities, and that DSL be based on industry standards to be compatible with competing providers' VoIP and other advanced services. By tying together DSL service with its voice services, SBC discourages consumers from using VoIP competitors. SBC has not had a mass market VoIP product,[174] but has used this required DSL bundling as means to discourage SBC broadband customer migration to primary line VoIP service, by requiring a circuit-switched voice line purchase as a condition of getting and keeping SBC broadband.

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[173] Tr. Vol. 9, pp. 1298-1299, AT&T Polumbo; Tr. Vol 11, p. 1746, SBC Kahan.

[174] Tr. Vol. 10, p. 1498, SBC Rice.

Some consumers prefer to buy packages of multiple services, while others prefer to buy individual services from different providers. Competitively priced individual offerings from different providers, however, allow competitors to compete on a service-by-service basis and, as a result, consumers benefit from more choices and better prices.[175]

SBC currently provides DSL service to subscribers in California only where the customer also subscribes to SBC voice service. Both the DSL and voice service is provided over a single cooper loop. SBC California provides the voice service over the low frequency portion of the loop ("LFPL") and SBCIS provides DSL transport over the high frequency portion of the loop ("HFPL").[176] Applicants claim that by requiring SBC California to offer standalone DSL would be in violation of federal authority that a loop constitutes a single network element that is not subject to further unbundling. SBC argues that such a requirement would entail the mandatory unbundling of the LFPL. SBC argues that the FCC preempted the states' ability to require such additional unbundling in its recent BellSouth Order.

Applicants claim there are numerous competitive alternatives to DSL, including ubiquitous cable modems, wireless broadband and other technologies, such that DSL unbundling is not necessary. Applicants argue that mandatory unbundling of DSL would actually impair competition by producing disparate regulatory treatment of the various modes of broadband connections.

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175 Reply Testimony of Ron Vidal, Level 3, Exh. 13, p. 31.

176 SBC Internet Services is an unregulated entity that is separate from SBC California.

We agree that in order to mitigate SBC's market power in this area, SBC should be required to offer DSL on a stand-alone basis, without tying DSL to a requirement also to take SBC voice service. We disagree with Applicants' claim that the requirement for SBC to offer DSL on a stand-alone basis constitutes a violation of federal authority that the low frequency portion of the local loop is not subject to further unbundling.

We conclude that SBC's current practice of refusing to offer stand-alone DSL harms competition by making it more difficult for competitors to provide voice service to customers subscribing to broadband Internet access over SBC's DSL facilities. The potential for this practice to harm competition will be amplified with the merger. We shall therefore adopt as a condition of the merger that SBC must offer DSL to consumers on a stand-alone basis without being tied to SBC voice service.

Applicants have not presented any valid objections to this condition. We disagree with Applicants' claim that a requirement to offer stand-alone DSL is the equivalent of a requirement to unbundle the loop through line sharing. On the contrary, SBC will continue to control the entire loop element, and will continue to be able to provide DSL to retail customers. SBC will be precluded, however, from forcing its DSL customers to also purchase intrastate local exchange service from SBC. Customers will thereby have the option of purchasing local voice service, including VoIP, from a competing carrier.

11. Prohibiting Preferential Access Rates Between SBC and Verizon

Qwest proposes that SBC and Verizon should be required to agree not enter into reciprocal arrangements to provide each other with more favorable access rates, whether based on "volume" or other factors, that would facilitate two segregated telecom monopolies within California. Qwest argues that if SBC continues to require customers to purchase its traditional wireline local voice product in order also to receive its broadband product, VoIP providers will be competitively disadvantaged in the marketplace.

Applicants object to this condition, arguing that it does not address any issue directly related to the merger, or any adverse consequence therefrom. Applicants argue that carriers do not need this condition in order for there to be fair competition.

We agree with Qwest that this condition is warranted to mitigate the risk of anti-competitive preferential arrangements. SBC shall be prohibited from engaging in reciprocal arrangements with Verizon to provide each other with more favorable access rates than either company offers to other competitors. Such a reciprocal arrangement would be discriminatory and anticompetitive.

12. Divestiture of Overlapping In-Region Facilities

a) Parties' Positions

Qwest and Level 3 advocate the "divestiture" of "overlapping" California in-region transport facilities.[177] Level 3 defines California In-Region Transport facilities as tangible assets (such as conduits, pole attachments, manholes, building entrance facilities, right of way agreements, fiber, transport equipment, support infrastructure equipment and collocation space), and intangible assets (such as AT&T's off-net transport purchase agreements or rights within the California service territories of SBC). In-Region Transport Assets would not

[177] Vidal (Level 3) Ex. 13, p. 15; Stegora Axberg (Qwest) Ex. 119, p. 17.

include AT&T's long-haul intercity backbone, but would include its intermediate distance network.

Level 3 argues that the combined effect of this merger with the Verizon/MCI merger significantly increase the risks of coordinated anti-competitive effects from the merged entities. After closing of the mergers, Level 3 doubts that MCI will continue as a significant competitor in SBC's territory (nor that AT&T will be a significant competitor within Verizon's territory) for the provision of transport services on a wholesale basis. Thus, mergers could mean the effective loss of both of the best-positioned alternative providers in the local transport market in SBC and Verizon territories.[178]

The divestiture proposed by Level 3 involves three components: The first component requires the conveyance of the California In-Region Transport Assets to a third party. The second component requires a purchase commitment from the sellers to continue to use those assets for a stated period of time. And in the final component, customer contracts, at the time of the closing of the transaction, would be retained by SBC and AT&T.[179]

For the purchaser of the In-Region Assets to be able to compete effectively going forward, Level 3 argues that the purchaser needs to obtain the scale benefits that such traffic volumes create. Level 3 thus proposes that the sellers of the California in-region assets be required to continue to purchase services from the new owner. The cost of maintaining AT&T's California In-Region Transport

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[178] Reply Testimony of Ron Vidal, Level 3, Exh. 13, pp. 19-20.

[179] Reply Testimony of Ron Vidal, Level 3, Exh. 13, p. 15.

Assets is amortized over large volumes of voice and data traffic over shared circuits as well as circuits dedicated to particular customers.

Level 3 acknowledges that divestiture of all of AT&T's customer relationships is infeasible. Level 3 believes it may be feasible, however, to require divestiture of some subset of AT&T's and MCI's existing customer agreements, such customer agreements where wholesale customers purchase basic transport services from AT&T or MCI.[180] If the merged entities desire to retain customers, however, Level 3 proposes that they be required to keep existing traffic on the divested California In-Region Transport Assets for some minimum period of time (with payment to the buyer for continuing to carry such traffic). Level 3 argues that this purchase commitment would also allow the purchaser sufficient time to build a customer base on the California In-Region Transport Assets so that it could compete with the incumbent even after expiration of the purchase commitment.[181]

Level 3 argues that a divestiture at the transport facilities level of these networks allows users of transport services to have an alternative access option other than the incumbent RBOC and to ensure that redundant physical facilities remain owned by different companies than the monopoly ILEC for the offering of competitive services.[182]

Applicants oppose such divestiture, arguing that it would undermine a key benefit of the merger, that is, the ability to provide end-to-end service to

[180] Reply Testimony of Ron Vidal, Level 3, Exh. 13, pp. 16-17.

[181] Reply Testimony of Ron Vidal, Level 3, Exh.13, pp. 16-17.

[182] Reply Testimony of Ron Vidal, Level 3, Exh. 13, pp. 15-16.

enterprise customers with enhanced features and services. The DOJ requires divestiture as a condition of its approval of a merger *only* when it finds that, absent such divestiture, the proposed merger would violate Section 7 of the Clayton Act, which prohibits mergers that are likely to lessen competition substantially in any line of commerce.[183] Applicants deny there is any network overlap or "significant adverse consequences" as referenced in § 854(c)(8). Applicants claim that AT&T is not in the wholesale special access business, and does not build local facilities either on speculation or to the common areas of commercial buildings to provide a competitive special access business. Applicants claim that AT&T has a retail focus and only provides fiber-to-the-floor (FTTF) building architecture (*i.e.*, directly to the customer) to serve the customer's proprietary space in on-net buildings after it has won the business of an enterprise customer.[184] As a result, Applicants claim, the equipment that AT&T installs can only be used to meet that specific customer's requirements.[185] Even if AT&T were to win another customer's business in the same building, or even on the same floor of a building, it might have to purchase special access

[183] *See* 15 U.S.C. § 18 (prohibiting mergers when "the effect of such [merger] may be substantially to lessen competition, or to tend to create a monopoly'). *See also, e.g., Application of AT&T Wireless Services, Inc. and Cingular Wireless Corporation For Consent To Transfer Control of Licenses and Authorization – File Nos. 001656065, et al.*, 19 FCC Rcd. 21522, ¶ 42 (2004) ("*AT&T-Cingular Order*") (describing standard of review DOJ applies to mergers).

[184] Giovannucci (JAs) Ex. 2 , p. 2.

[185] Giovannucci (JAs) Ex. 2 , p. 2.

from SBC to serve that customer.[186] AT&T only very rarely builds local access to common areas of a commercial building or floor of a building.

Applicants claim that Qwest witness Axberg provides no evidence of overlapping facilities in California, and does not substantiate the premise for her divestiture request, namely the elimination of concentration of special access facilities in California.[187] Axberg has no idea how many Competitive Access Providers ("CAPs") exist in California or the number of CLEC route miles or fiber miles in California.[188] Ms. Axberg has no idea whether there is any concentration of special access facilities in California that would warrant a divestiture of Applicants' facilities. She believes that the majority of Qwest's special access purchases in California are for interstate services.[189]

Level 3, however, presented evidence of overlapping facilities. AT&T's own SEC public documents which it filed in support of this case show that the company has a large amount of fiber transport, and that it is in the business of leasing that transport capability to competitive providers.[190] This business segment was important enough to merit special mention in AT&T's SEC filing.[191]

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[186] Giovannucci (JAs) Ex. 2 , p. 2.

[187] Stegora Axberg (Qwest) Ex. 119, p. 20.

[188] Stegora Axberg (Qwest) 14 Tr. 2178-2179.

[189] Stegora Axberg (Qwest) 14 Tr. 2171.

[190] Exhibit 66; Tr. Vol. 11, pp. 1657-1659, SBC Kahan. See also Reply Testimony of Qwest witness Pam S. Axberg, Ex. 119, p. 4 (Qwest, as a California CLEC, purchases special access and transport from SBC in California).

[191] Tr. Vol. 11, p. 1660, SBC Kahan.

In addition, AT&T indicates that it has "an extensive local network serving business customers in 91 U.S. cities. [Its] local network now includes 158 local switches and reaches more than 6,400 buildings with over 8,200 metropolitan SONET rings."[192]

In California, AT&T acquired SONET rings and metropolitan fiber designed to serve multiple customers in its acquisition of TCG, a competitive access provider and CLEC, in four major metropolitan areas: Sacramento, San Diego, San Francisco and Los Angeles, all of which are in SBC's California service area.[193] AT&T has fully integrated those TCG facilities into its own network.[194]

Applicants further argue that that divestiture would harm rather than benefit customers, and that any such customer divestiture would frustrate the rights and interests of customers by forcing them to deal with suppliers they have not chosen, and who may lack the ability to deliver the same levels of service and proprietary features for which the customers have contracted.[195]

Despite the desire of many enterprise customers for end-to-end service by one carrier, divestiture would force them to rely on a new facilities operator. AT&T's local facilities are mainly used to provide retail services to enterprise

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[192] Ex. 66

[193] Tr. Vol. 8, pp. 1126-1127, AT&T Giovannucci; Tr. Vol. 10, p. 1369, SBC Rice.

[194] Tr. Vol. 8, pp. pp. 1126-1127, AT&T Giovannucci.

[195] Vidal (Level 3) Ex. 13, p. 18 ("many of the more sophisticated enterprise customers receive proprietary services or service level agreements from AT&T that would be difficult for a competitor to quickly replicate"); *id.* at 17 ("Customers will find th[e] compelled transfer of their agreements to be unattractive").

customers that have chosen AT&T over many other competing suppliers, and that it "is infeasible" to "convey[]" these customers "involuntarily" to new suppliers.[196]

b) Discussion

We conclude that Level 3 and Qwest have not provided sufficient justification to warrant adopting their divestiture proposal.

We decline to require the divestiture of overlapping in-region facilities. We agree that there is evidence that AT&T and SBC have some degree of overlapping facilities, particularly through AT&T's acquisition of its TCG affiliate. Yet, some of the evidence presented regarding overlapping facilities relates more to AT&T's national network, without specific delineation of the extent to which the overlap applies within California territory. In any event, we are not persuaded that the degree of overlapping facilities within California is sufficient to justify divestiture as a remedial condition. We conclude that the potential disadvantages of implementing such a complicated proposal outweigh any possible advantages that might be realized. Although the sponsoring parties have set forth broad outlines, they have not adequately explained in detail how the relevant facilities would be identified or the administrative processes required for implementing such divestiture. Vidal identifies overlapping facilities as "In-Region Transport Assets" and provides a very general, high-level explanation of these assets.[197] Mr. Vidal, however, doesn't explain how such assets would be identified, how the divestiture process would work, what

[196] Vidal (Level 3) Ex. 13, pp. 16-18.

[197] Vidal (Level 3) Ex. 13, p. 15.

vehicle the Commission would use to accomplish the divestiture or a timetable to accomplish divestiture. Qwest's witness Axberg provides a different but equally high-level claim of "overlapping" facilities "including, but not limited to fiber rings, collocation facilities, entrance facilities and building entrance loops."[198]

Like Mr. Vidal, Ms. Axberg provides no explanation of how these facilities would be identified or divested, or how the Commission would accomplish the divestiture. Moreover, the divestiture would have the potential to be disruptive to customers served by the divested facilities. Applicants note that any California-specific facilities divestiture order would force multi-state companies which had purposely contracted for a single provider to serve locations in multiple states to restructure their telecommunications services, either in the short term, by agreeing (potentially against its will) to use multiple providers where previously it had used only one, or in the longer term, by finding an entirely new provider able to serve its needs in all states. Either result would cause additional costs and inefficiencies for the customer.

Level 3 claims that such problems would be avoided by requiring Applicants to separate AT&T's network between its intercity "backbone" and its local facilities, and requiring divestiture of only the local facilities. Vidal (Level 3) Ex. 13, p. 15-17. Level 3's witness Vidal argues that customers would enjoy the full benefits of their bargains if AT&T continues to serve them, but is required to purchase access services from the new owners of the divested facilities. Level 3's plan, however, could create the very customer disruptions and inefficiencies that are improper, and that many customers – including many

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[198] Stegora Axberg (Qwest) Ex. 119, p. 20.

who specifically wish to have an end-to-end solution and believe the proposed merger is in the public interest for precisely this reason, among others – would prefer to avoid. Divestiture would require that the combined company pay the new carrier for services, increasing the cost of service, and would eliminate Applicants' ability to use their existing systems fully to provision, monitor, and restore services on an end-to-end basis.[199] In addition, we conclude that the other conditions that we are adopting to mitigate SBC's market power are sufficient without resorting to the extreme measure of divestiture.

ORA has also proposed divestiture of AT&T's consumer local and long distance business. As part of its divestiture proposal, ORA proposed that the purchaser of the divested services would need to be able to obtain UNE-P at TELRIC-based rates. We likewise do not believe that divestiture as proposed by ORA is a practical remedy to mitigate perceived adverse competitive impacts. One of the basic reasons for the merger is to achieve synergies from combining AT&T's business operations with those of SBC's. Divestiture of AT&T business components would undermine the very sorts of synergistic benefits that the merger is aimed at producing. Moreover, ORA's proposal would envision that the purchaser of divested facilities obtain UNE-Ps at TELRIC-based rates. Such a condition, however, would be contradictory to the TRRO calling for the elimination of UNE-P. Accordingly, we decline to order divestiture of AT&T assets.

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[199] Giovannucci (JAs) Ex. 1, pp. 2, 5.

13. Pac-West Proposal Regarding Packet-Switched Interconnection

a) Parties' Positions

Pac-West proposes that as a condition of the merger, that SBC certificated public utility affiliates in California consent to participate in arbitration proceedings conducted by this Commission pursuant to Section 252 of the Communications Act to establish terms and conditions of interconnection to include all technologies and network architectures deployed by SBC affiliates in California, including but not limited to all packet-switched network technologies. Pac-West further proposes that SBC waive any claims that such interconnection obligation involving all of its deployed network architectures exceeds the scope of Section 252 permissible arbitrations.

Pac-West argues that this condition is required to mitigate potential harm to competition from the merger, specifically in view of SBC's position that its obligations under Section 251 and 252 of the Communications Act to interconnect its network with competitors on a non-discriminatory basis do not apply to its "packet-switched" network.[200] SBC believes that its statutory interconnection obligations are limited only to the circuit-switched portions of its network even if packet-switched portions of that network are used to provide regulated telecommunications services.

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[200] In a traditional circuit-switched telephone network, a fixed communications path is established between calling and called numbers through a hierarchical system of switches connecting dedicated transmission paths. In a packet-switched network, however, no such dedicated path exists. Instead, the message content is broken into "packets" of data, each of which is transmitted individually through the packet-switched network, to be "reassembled" near the end of the destination point, and delivered to the called party by a "router."

Pac-West thus argues that the lack of nondiscriminatory interconnection between competitors' packet-switched networks with SBC facilities will make intermodal competition with SBC telecommunications services impossible. Although the trend from circuit-switched to packet-switched technology is expected to continue irrespective of the merger, Pac-West claims that the pace of transition will accelerate as a result of the merger. Pac-West points to the accelerated transition schedule as a merger-related problem for which remedial mitigating conditions are warranted to prevent adverse merger impacts particularly regarding impediments to intermodal competition. Moreover, Applicants have pointed to intermodal competition as evidence that the merger will not be anticompetitive. Yet, Pac-West argues that intermodal competition cannot succeed without nondiscriminatory interconnection for packet-switched networks.

b) Discussion

We conclude that an appropriate condition of the merger is that SBC agree to include packet-switched networks within the scope of interconnection rights and obligations subject to negotiation and arbitration with other telecommunications carriers. A primary claimed benefit of the merger is that it will lead to acceleration of the conversion of Applicants' combined networks to a unified and completely packet-switched architecture. This packet-switched conversion will provide advanced forms of service more efficiently. At the same time, Applicants have pointed to intermodal competition as a significant factor that will mitigate any potential concerns that the merger will give SBC increased market power. Yet, in order for intermodal[201] competition to be effective over time, each competing telecommunications network must be able to exchange traffic originated on its own network, but destined for a called subscriber on a different competing network, on fair and nondiscriminatory terms. Pac-West's proposed condition accomplishes this result.

Pac-West witness Taplin testified about the ability of packet-switched network operators to discriminate against packets of competitors. Thus, the mitigating condition proposed by Pac-West is appropriate to prevent SBC, by converting to packet-switched network technology, from being able to degrade the performance of calls made to or from customers of carriers such as Pac-West.

Applicants provide no convincing evidence to refute the claims made by Pac-West concerning the potential harm from SBC's refusal to include packet-switched technologies within the terms and conditions subject to its interconnection agreements. Applicants do not refute Pac-West's claim concerning the potential for competitive harm. Instead, Applicants base their opposition on the claim that Pac-West's proposal would constitute unlawful Internet and IP network connection obligations. In making this claim, Applicants cite to an order of the FCC indicating that the various obligations and entitlements under the Act attach only to entities providing *telecommunications* services, not *information* services.[202] Yet, Pac-West's proposed condition does not address information services, and does not require that any individual services

[201] Ex. 110, Testimony of Taplin (Pac-West) at 2

[202] Applicants' Opening Brief at 66, note 311, citing "in the Matter of IP-Enabled Service, WC Docket NO. 04-36, Notice of Proposed Rulemaking, FCC 04-28, ¶¶ 24-27) rel. Mar. 10, 2004 (IP Enable Services NPRM).

offered by means of interconnected packet facilities be regulated by this Commission versus the FCC. Pac-West's condition only applies to telecommunications services exchanged between certificated carriers. AT&T and SBC would remain free to commercially negotiate peering arrangements with non-common carrier participants in the Internet marketplace, as well as to provide Internet services on an unregulated basis. [203]

Applicants also object to a requirement that SBC "consent" to state arbitration proceedings to establish the terms and conditions of interconnection to SBC's networks, that "include[s] all technologies and network architectures deployed by the SBC affiliates in California, including but not limited to all packet switched network technologies." Applicants claim that Pac-West's condition would have SBC expressly "waive" its rights concerning the proper scope of arbitrations under the Telecommunications Act. Applicants claim that it would be unlawful for the Commission to impose such a condition.

We disagree with Applicants' claim that it would be unlawful to impose this condition. Section 251(c)(2) imposes network interconnection obligations on ILECs and Section 251 is subject to the negotiation and state commission arbitration requirements of Section 252. State commissions have primary regulatory oversight responsibilities for all network interconnection obligations arising under Section 252. Moreover, packet-switched facilities can and are used to provide services which the FCC has expressly found to be basic

[203] Pac-West Opening Brief at 26.

telecommunications services.[204] Accordingly, we find this condition to be lawful and necessary in order to mitigate the adverse effects, as noted above.

14. Telscape Proposal

Telscape proposes that as a condition of approving the merger, AT&T and its affiliates provide access to rights-of-way, conduit space, interoffice transport, and fiber loop facilities at the same rates and terms that would apply if those facilities were owned by SBC-CA.[205] Telscape asks that the AT&T/TCG networks be subject to ILEC interconnection obligations. Applicants respond that federal law precludes the imposition of ILEC interconnection obligations on CLECs and IXCs.[206]

Telscape also proposes a requirement that SBC California timely repair any substandard residential copper loop facilities reported by CLECs in order to ensure that these legacy facilities are available to continue to serve the interests of end-users in economically disadvantaged areas. Telscape further proposes a requirement that SBC California charge mechanized service order charges for all

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[204] Pac-West's Opening Brief at 8, citing Petition for Declaratory Ruling That AT&T's Phone-to-Phone IP Telephony Services are Exempt form Access Charges, 19 FCC Rcd 7457, 7465-67 (2004)

[205] By this request, Telscape also asks that ILEC interconnection obligations be imposed on AT&T's IP backbone.

[206] *See US West Communications, Inc. v. Jennings*, 304 F.3d 950, 960 (9th Cir. 2002) (recognizing that only ILECs must provide access to poles, ducts, conduits, and rights-of-way); *US West Communications, Inc v. Hamilton.*, 224 F.3d 1049, 1052-55 (9th Cir. 2000) same); *AT&T Communications of the Midwest, Inc. v. US West Communications, Inc*, 143 F. Supp. 2d 1155, 1162 (D. Neb. 2001) (upholding FCC regulations requiring only ILECs to provide access to poles, ducts, conduits, and rights-of-way); *Compare* 47 U.S.C. § 224 and § 251(b) *with* 47 U.S.C. § 251(c).

electronically-submitted service orders for basic two-wire residential loops in order to ensure that SBC California continues to make necessary improvements to its OSS following the acquisition of AT&T.

Applicants oppose the Telscape proposal relating to OSS improvements, noting that Telscape raised and lost this issue in a complaint proceeding in which it sought to eliminate all semi-mechanized charges on electronically submitted local service requests.[207] Applicants claim that Telscape has not provided any valid legal basis for rehearing or petition for modification as required by the Commission's rules.[208]

Applicants argue that Telscape's proposal is also contrary to federal law in seeking a "requirement that SBC-CA offer a basic two-wire residential loop product on a commercial wholesale basis at a price at least 50% below the TELRIC rate …."[209] Federal law establishes a pricing standard for UNEs and specifies that rates shall be based on the cost of providing the network element.[210] Under 47 U.S.C. section 252(d)(1), ILECs may charge a "just and reasonable rate" for unbundled network elements identified by the FCC, and the FCC has

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[207] *Opinion Resolving Complaint*, D.04-12-053 (Dec. 16, 2004) ("We conclude that Telscape has not demonstrated that its broad objections to the functioning of SBC-CA's operational support systems (OSS) are well founded…" at p. 3).

[208] *See, e.g.*, Rules 47 and 86.1 of the Commission's Rules of Practice and Procedure.

[209] Condition no. 47.

[210] *See* 47 U.S.C. § 252(d)(1)(A (rates "*shall be*…based on the cost … of providing the interconnection or network element").

adopted “total element long-run incremental cost,” or TELRIC, as the applicable pricing standard.[211]

We are not persuaded that the conditions proposed by Telscape are necessary to mitigate merger effects. We previously denied Telscape’s arguments regarding OSS improvements in the above-referenced complaint proceeding leading to D.04-12-053. We likewise decline to adopt it here.

V. Other Public Interest Criteria Considered Under Section 854(c)

In addition to § 854(b), Applicants must satisfy the public interest criteria under § 854(c), as previously enumerated. We adopt conditions as set forth below to ensure compliance with § 854(c).

A. Maintaining or Improving Financial Health

1. Parties’ Positions

Pub. Util. Code § 854 (c) (1) requires that the merged company maintain or improve the financial condition of the resulting public utility. The Joint Applicants assert that the complete organization created by this merger would enjoy good financial health. (Ex. 43, p. 21, SBC/Kahan.) AT&T has experienced increasing financial challenges in recent years which have resulted in thousands of layoffs and created financial uncertainty for workers and shareholders. Applicants claim the merger creates a stronger combined company through which AT&T and its affiliates will benefit from SBC’s stronger balance sheet and better access to capital.[212]

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[211] 47 C.F.R. §§ 51.503(b) and 51.505(b)(1). The Supreme Court upheld this standard in *Verizon Communications v. FCC*, 535 U.S. 467 (2002).

[212] Kahan (JAs) Ex. 43, p. 21.

Applicants' claims focus on the overall operations of the combined company, but do not address specific increased risks on the regulated utility SBC California's financial condition. ORA argues, however, that this merger may adversely impact SBC California's financial condition, and may increase the potential for the parent company and affiliates to exploit regulated California utility operations and cause the latter financial harm.

ORA raises the concern that SBC California's regulated revenues could be eroded by SBC affiliates' unregulated VoIP offerings which contribute substantially to regulated SBC California's intrastate revenues. (Ex. 12C, p. 62, ORA/Tan.) This merger will make it possible to deploy IP-based services, including VoIP, at a faster pace. (A.05-02-027, Ex.43, JA-SBC/Kahan.) VoIP normally provides a wide range of unregulated services including local, toll, and custom-calling features. Such features contribute substantially to regulated SBC CA's intrastate revenues. (Ex. 12C, p. 62, ORA/Tan) Other SBC entities which offer IP platform services may also erode traditional high capacity (and high revenue-generating) data services, such as DS1, DS 3, which currently comprise category II revenues.

SBC classifies the costs for enhancing the network to provide IP-type services as regulated costs (Ex. 12C, p. 65, Tan/ORA) even though these IP-based services are considered non-regulated services. If non-regulated affiliates do not share properly in network upgrade costs, network reliability could suffer in the long run. Alternatively, if SBC California faces the prospect of being unable to meet its obligation to serve, it may likely seek rate increases. ORA reports that SBC California has been raising rates for many services, including recategorized services, such as business toll, centrex, Custom 8, etc., and the rate increases are substantial.

2. ORA Proposed Mitigation Measures Relating to Section 854(c)(1)

To mitigate financial risks created by the merger, ORA proposes that the Commission ensure that the revenues follow costs and vise versa. The last NRF audit found that SBC California booked several million dollars of the DSL deployment and development costs in SBC CA's books above the line.[213] ORA understands that investment for the new roll out of extending fiber to the node or customer premises are all booked above the line. Most of these costs have not been audited. ORA thus proposes that the Commission make sure that where costs are booked as intrastate costs above the line, the associated revenues are also captured as intrastate revenue above the line; and vice versa. Unless network costs are properly allocated based on the revenues generated, not only by traditional voice grade, but also IP revenues, network reliability may suffer in the long term.

We agree with the principle that revenues and associated costs be properly matched. It is not clear from ORA's testimony, however, exactly how this principle translates into a specific proposed condition on the merger. ORA discusses accounting issues that were identified in the last NRF audit, all of which relate to pre-merger activities. While we do not diminish the general importance of these accounting issues, we do not view such issues as merger impacts, per se. Accordingly, we do not view this proceeding as the applicable forum to address compliance with the accounting issues raised in the NRF audit.

ORA also recommends that the Commission review the possibility of directing SBC CA to provide IP-based services itself. It is possible that the whole

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[213] Telecommunications Division Audit Report,Vol II, p.19-3.

network will eventually evolve into a packet-switched based, IP network. ORA argues that the Commission has to assess the implication of such network transformations to make sure that the regulated utility can continue to meet its obligation to serve.

ORA does not appear to be proposing a specific merger condition here, but only suggesting that the Commission consider the possibility of directing SBC California to provide IP based services itself. We reserve the option of considering such a possibility at a future time if there appears to be sufficient warrant to do so. Without further elaboration on this proposal by ORA, we are not persuaded that such a study is necessary at this time.

ORA also proposes that the Commission impose a "first priority" condition on the SBC holding company. In fashioning this condition, ORA draws upon D. 02-07-043 in which the Commission clarified a requirement pertaining to the holding company systems of the major California energy utilities. In D. 02-07-043, the Commission required energy utilities' holding companies to infuse capital into the regulated utility when needed to meet its obligation to serve customers. This requirement, known as the "first priority" condition, was intended to protect the regulated utility from being unfairly exploited by its parent and affiliates. For purposes of this proposal, ORA incorporates the principle previously adopted by the Commission in D.02-07-043 requiring that the funding needs of the utility must take first priority. In this regard, the Commission has previously stated:

> The holding company must infuse capital into the utility when needed to meet its obligation to serve.[214]

The Commission emphasized in D.02-07-043 that it will weigh the regulated utility's interests when determining the impact of affiliate ventures.[215] The Commission noted its desire and statutory duty to ensure that the holding company system does not eviscerate a regulated utility's ability to fulfill its obligation to serve, and affirmed that a first priority condition, by "requiring its holding company to give the utility preference over all competing potential recipients of capital resources" is necessary to ensure the utility's ability to serve.[216]

Applicants object to ORA's proposed conditions, arguing that the Commission already has its own affiliate transaction rules and requirements.[217] Applicants further argue that the FCC has implemented Customer Proprietary Network Information ("CPNI") protections.[218] Applicants contend that the merger does not have any effect on these standards.

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[214] D.02-07-043, *mimeo.*, Ordering paragraph 2.

[215] D.02-07-043, *mimeo.*, p.30.

[216] *Id.*

[217] *See, e.g., Order Instituting Rulemaking on the Commission's Own Motion to Adopt Reporting Requirements for Electric, Gas, and Telephone Utilities Regarding Their Affiliate Transactions*, Decision 93-02-019, 48 Cal. P.U.C.2d 163 (1993).

[218] *In the Matter of Implementation of the Telecommunications Act of 1996: Telecommunications Carriers' Use of Customer Proprietary Network Information and Other Customer Information*, Third Report and Order and Third Further Notice of Proposed Rulemaking, CC Docket Nos. 96-115, 96-149, 00-257, FCC 02-214, (rel. July 25, 2002)

Footnote continued on next page

Joint Applicants seek to form a global, vertically-integrated telecommunications company. In granting approval, the Commission has the authority to place conditions on the proposed transaction to meet the standards for approval under § 854. The Commission has this authority even if members of the extended SBC corporate family are not subject to the Commission's jurisdiction.[219]

We shall adopt the "first-priority" condition, as proposed by ORA. We agree with ORA that this condition is appropriate as a mitigation measure here. Applicants have pointed to increased capital spending on advanced technologies as one the anticipated effects of the merger. While such capital expenditures may benefit certain categories of customers, there is also the risk that reduced funds may remain available for traditional regulated services. While D.02-07-043 applied to energy utilities, this principle also applies to holding companies controlling regulated ILEC operations. Under a holding company structure, a regulated utility may be exploited by its parent and affiliates. Ex. 12C, pp. 59-60 & p. 63, citing D.86-01-026, ORA/Tan). Nothing in the record demonstrates that SBC California will be relieved from the various payments it is making to its parent and affiliates. Since SBC acquired Pacific Telesis in 1997, there has been a constant flow of capital/cash from SBC CA to its parent and affiliated companies.[220] ORA raises the concern, however, that SBC CA may face

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(*Third CPNI Order*), 2002 WL 1726815; 2002 FCC LEXIS 3663; *see also* 47 C.F.R. §§ 64.2005, 64.2007-64.2009.

[219] *PG&E Corp. v. Public Utilities Com, supra,* 118 Cal.App.4th at pp. 1197-1198.

[220] Ex. 12C, pp. 57, 58, ORA/Tan.

additional financial pressure from the new affiliated entity formed by the merger.[221] To mitigate the risk that increased capital spending by the merged company is used in a manner that deprives regulated utility operations of necessary funds, we shall therefore adopt ORA's proposal. Thus, as a first priority condition, we shall require that SBC give the regulated ILEC preference over all competing potential recipients of capital resources necessary to ensure the ILEC's ability to serve.

B. Effects on Quality of Management

Section 854(c)(3) requires the Commission to consider whether the proposed merger will "[m]aintain or improve the quality of management of the resulting utility doing business in the state. Applicants have claimed that the overall management of the combined company will be enhanced by combining the separate strengths of the two companies. ORA has raised issues over potential management practices relating to how resources are allocated between regulated and unregulated operations. We address that issue separately in our discussion of how the merger will affect the financial health of the combined utility and our ability to regulate effectively. In other respects, we find no evidence that the quality of management will be adversely affected by the merger. Thus, subject to our discussion of separate affiliate reporting requirements, we find that Applicants have satisfied Section 854(c.)(3) relating to the quality of management.

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[221] Ex. 12C, p. 58, ORA/Tan.

C. Effects on Public Utility Employees

Section 854(c)(4) requires that the merger be fair and reasonable to public utility employees. ORA claims that SBC has employed a strategy to use SBC California workers as needed in its nationwide workforce, available to shore up performance in other states when SBC carriers in states with stricter standards fall short of those state's standards." (Ex. 26C, p. 70, ORA/Piiru) ORA argues that as long as SBC California adheres to standards that are not as strict as those of the other SBC carriers, California will be vulnerable to service quality arbitrage, and the threat that its workforce will be re-deployed to SBC carriers in other states with stricter standards when standards are not met in those states.

Given the financial incentive to meet service quality standards in other states, ORA expresses the concern that SBC may again be motivated to shift staff resources from states with lax standards, such as in California, to those with higher standards and penalties as a way to minimize the parent company's overall financial burden and maximize profit. These financial incentives can harm California ratepayers as resources and personnel are shifted to other states with tougher standards and penalties, and staff reductions are disproportionately made to California where penalties for service quality degradation are less likely. (Ex. 26C, Reply Testimony of Dale Piiru, p. 80)

ORA also identifies SBC's offshore outsourcing policies as an additional threat to California jobs (Ex. 26C, p. 84, ORA/Piiru). With the merger, SBC will have enhanced opportunities to engage in such offshore outsourcing. Even though SBC California does not have its own outsourcing policies or contracts, the SBC holding company has a significant outsourcing function. (Tr., Vol. 9, pp. 1328-1334, AT&T/Polumbo). Since SBC California is the largest of the SBC carriers, California could suffer proportionately from the holding company's offshore outsourcing policy. We agree with ORA's general concerns and shall adopt this condition.

While ORA raises general concerns with how SBC allocates its employees between California and other states, or through offshore outsourcing, these concerns existed before the merger. Other than raising the possibility that there will be more opportunities for SBC to relocate employees after the merger, ORA has not established a specific link between the merger, per se, and how employees will be allocated. Moreover, ORA has not provided a specific quantifiable measure that could be applied with respect to how employee resources are utilized or allocated. In any event, the conditions we are adopting relating to service quality will mitigate any risk of excessive employee job loss in California.

In addition, we are not predisposed to enforce utility business plans, which would represent a departure from our policy to create incentives for utility managers to assume the risk of their operations rather than rely on our constant oversight. Accordingly, we decline to adopt merger conditions relating to public utility employees. We find that § 854(c)(4) has been adequately satisfied.

D. Effects on Public Utility Shareholders

Section 854(b)(5) requires the Commission to consider whether the proposed merger will "[b]e fair and reasonable to the majority of all affected public utility shareholders." Applicants have argued that the merger will enhance the financial strength of the combined company by the synergies created from the merger. No party argues that the merger will be unfair or unreasonable to existing or future shareholders.

The merger will be fair and reasonable to affected public utility shareholders, as reflected by the approval of the merger by 98% of AT&T's shareholders. Accordingly, we find that Section 854(b)(5) has been satisfied.

E. Effects on State and Local Economies and Communities of Interest

Section 854(c)(6) requires that the merger be beneficial to state and local economies and to local communities. Various parties, as well as speakers at the PPHs, argue that the merger will create significant risks for the state and local economies, and particularly underserved segments therein, served by SBC and AT&T through the effects of diminished competition. TURN argues that diminished competition is harmful to the affected state and local economies. SBC does not compete for residential customers outside of its traditional ILEC service territory, and has no plans even to maintain AT&T's consumer lines in California outside of SBC California's ILEC territory. Thus, TURN raises the concern that the local economies in the Verizon California service territory may suffer by losing one of the main competitive options previously available in the form of a stand-alone AT&T.

TURN also raises the concern that state and local economies may suffer through SBC's cost-cutting measures to generate merger savings. Applicants have suggested that nearly 13,000 jobs will be lost due to the merger.[222] Given the substantial portion of the workforce that is located in California, TURN infers that a significant portion of those lost jobs will be from California. ORA states that there is a potential loss of more than 3,000 California jobs. ORA argues that

[222] TURN Opening Brief, note 356, citing Applicants' Special Analyst Meeting 2/1/05.

job loss will have a significant adverse impact on the California economy, which would be a basis for rejection of the merger pursuant to § 854(c)(6). TURN also raises the concern that Applicants' planned savings from the merger will come, in part, from reducing purchases from California-based suppliers. Applicants have failed to provide any estimate of the magnitude of such merger-related losses.

TURN also raises concern that the merger will have particularly harsh effects on underserved communities. TURN calls attention to Applicants' claims that the merger will create practically no benefit relating to the bulk of SBC residential and small business customers. TURN views such claims as indications of SBC's motivation to export merger-related savings from California to Texas and beyond.

Similar concerns regarding the effects on underserved communities were expressed by other parties including Greenlining, LIF, DRA, and CFTC. Various parties presented testimony and proposals regarding the need for mitigation measures relating particularly to specialized segments of the communities within which Applicants serve. Two of these groups, Greenlining and LIF entered into a settlement with Applicants to propose a compromise whereby certain commitments would be made by Applicants. We first review the evidence and proposals presented in testimony on these issues, and then evaluate the evidence in view of the subsequent settlement entered into by certain parties.

1. Diversity Issues

Greenlining specifically questioned how the merger will impact supplier diversity. Greenlining raises this concern, particularly because AT&T has compared unfavorably with SBC in its track record regarding supplier diversity. Greenlining claimed that SBC appears to be doing little more than the bare minimum to identify diverse suppliers through unique channels and innovative measures. Greenlining argued that unless SBC and AT&T set an aggressive minority contracting goal for the merged company and commit to go beyond the typical means to seek diverse suppliers, the merged company's supplier diversity record will be weak. Witness Gamboa supported a goal of a 30% increase by 2007 in the merged company's supplier diversity.

Greenlining also expressed concern about the lack of diversity among the leadership of the merged company and its potential inability to serve the diverse populations of California. Greenlining states that minority groups are underrepresented among the most highly paid employees of SBC. The Application, however, identified no plans regarding how the merged firm's workforce will reflect the diverse populations of California. Greenlining asked the Commission to urge Applicants to address weaknesses in their diversity policies as a condition of the merger, and to approve a reporting process for tracking progress in this regard.

2. Philanthropy Issues

Greenlining also was critical of SBC's philanthropy to underserved communities. Greenlining claims that SBC's current philanthropy to underserved communities is very low compared with its executive compensation. Greenlining argues that a major company interested in becoming a good corporate citizen should contribute at least 2% of pre-tax income in cash philanthropy with 80% of that philanthropy going to benefit underserved communities. SBC and AT&T have not yet reached this goal, and Applicants established no charitable giving goals in their Application. Greenlining recommended a commitment of $40 million per year in charitable giving over a 10-year period, with at least 80% going to low-income, minority and underserved communities. Gamboa testified that this level of giving is consistent with the philanthropy of other large regulated corporations.

3. Bridging the "Digital Divide" for Underserved Consumers

Greenlining also advocated measures to bridge the "digital divide" between underserved low income and minority customers versus more affluent customers. Greenlining proposed that the merged company commit to free wireless broadband for public schools and libraries located in low-income areas and households in very low-income areas, as well as reduced rates for broadband for qualifying low-income households.

LIF likewise notes that in contrast to this merger, in the SBC/Pacific Telesis merger of 1997, important § 854(b) benefits were created for underserved communities. D.97-03-067 approved "Community Partnership Commitment…activities to support customer service, underserved markets and local communities."

LIF believes that specific § 854 short and long-term commitments should be directed at the most vulnerable segments of California's telecommunications customers to bring about economic and educational benefits for underserved communities, especially in terms of broadband access and Universal Service.

Subsequent to approval of the SBC/Pacific Telesis merger, SBC was found to have engaged in highly aggressive and deceptive marketing practices targeted, in part, at Latinos and other language minority communities. Some of the unethical activities centered around expensive packages of services which customer service representatives were compelled to try to sell on every service call, regardless of the customer's reason for calling. Thus, as a condition of the merger, LIF proposed long-term guarantees on low-cost basic unbundled service options without aggressive marketing. LIF argues that it is critical that access to basic local service at a low cost be protected and guaranteed through the Commission's oversight power and through the Applicants' voluntary commitments.

LIF argues that Latinos and other immigrant communities are particularly susceptible to unethical marketing for a variety of reasons. Therefore, LIF believes that a condition of the merger should be a "zero tolerance" policy on slamming, cramming and marketing abuse for the merged company, especially as it pertains to language minority customers. The Commission announced its zero tolerance policy for marketing abuse in its *Rulemaking on the Commission's Own Motion to Consider Adoption of Rules Applicable to Interexchange Carriers*, R.97-08-001, I.97-08-002.

LIF also expresses concern Applicants make no specific commitments with respect to Universal Service. LIF believes commitments in this area are important particularly as landline service and the funding base for Universal Service erodes. LIF believes the question of funding for Universal Service programs needs to be examined and the definition of "basic service" must be retooled to match advanced technologies. LIF argue that low-income customers are constrained to "horse and buggy" technology of telephones only rather than Internet with the Universal Service program. LIF thus argues that mandatory funding of Universal Service for the long term should be a condition of this merger as it was with the Pacific Telesis/SBC merger, including the creation of a Blue Ribbon Task Force to study funding and advanced technology issues.

4. Concerns of Consumers with Disabilities

Disability Rights Advocates (DRA) sponsored testimony regarding disabled consumers' interests in promoting affordability, availability and accessibility of telecommunications services. DRA seeks to ensure that the new merged entity provides accessible programs and services to consumers with disabilities, and that basic service will continue to be available at affordable rates, particularly in light of the trend towards “bundled” services.

DRA seeks assurances that the merged entity will provide bills and other communication in an accessible format, such as Braille, large print, and other accessible, electronic formats. Consumers with disabilities are also concerned about communication problems with the new entity due to changes in management and personnel, particularly regarding service installations, billing disputes and other transactions, and the specialized needs of customers with disabilities. DRA proposes that as a condition of the merger, SBC’s website, including the portions of the website that allow individual transactions to take place, be fully accessible to consumers with disabilities.

DRA claims that the Applicants have not addressed the concerns identified by the disability community, or how the new entity would maintain or improve the quality of service to customers with disabilities. Prior to its merger with SBC, Pacific Telesis was recognized as a leader on disability related issues within California, particularly in its commitment to Universal Design principles. The merger between SBC and Pacific Telesis imbued SBC with a new sense of commitment to consumers with disabilities. AT&T, however, lags behind SBC on issues of concern to the disability community

The Applicants assert generally that the new entity will be “well equipped to increase investment in research and development, and to bring new products and services to customers.” (Application at 30.) DRA questions whether this claim is focused on products and services that can be offered to the low-income market, including people with disabilities. Applicants do claim that potential new products and services may include speech and text technologies that would be beneficial to customers with disabilities. However, there is no mention of the affordability of such services.

If the merger proceeds, DRA proposes that the Commission condition approval on SBC's commitment to ensure that the telephone, as a basic communication tool, remains a low cost service of the new entity in the future.

DRA also proposes that the Commission require specific commitments by the Applicants to increase funding levels and spending on disability programs and services, consistent with the proposed entity's increased financial resources. Because programs and services for consumers with disabilities can be costly, DRA expresses concern that they are at risk for potentially coming into conflict with a new entity's anticipated focus on cost-cutting efficiencies. Without explicit requirements in support of these services, DRA argues, such programs may be in jeopardy. DRA proposes an ongoing commitment to providing specialized customer service programs for consumers with disabilities, including improved training for dedicated representatives addressing accessibility resources, as well as training for other customer service representatives so that they are aware of the dedicated program's existence and are prepared to refer customers to the dedicated program when appropriate. DRA also proposes expanded outreach to the disability community regarding the existence of such programs, including outreach in accessible formats.

To the extent that consumers are offered the opportunity to pay lower prices for a service when purchasing "bundled" services at the same time, DRA argues that all of the "bundled" services should be accessible to persons with disabilities. DRA proposes that if any services in a bundled offering are inaccessible, such inaccessibility must be transparent, and people with disabilities should be permitted to drop such services from the bundle and receive a correspondingly reduced rate, without increased charges for the remaining services.

In reference to Universal Design principles, DRA proposes that the new entity expand its commitment to developing and supporting products and services meeting its principles through in-house efforts and through procurement involving products provided by outside manufacturers.

SBC currently maintains a Telecommunications Consumer Advisory Panel and a Disability Advisory Group, both of which provide valuable advice to SBC regarding the implementation of its policies that benefit persons with disabilities. DRA proposes that, at a minimum, the new entity be required to maintain comparable or expanded internal committees so that the opinions and ideas of persons with disabilities will continue to be heard and have influence within the new entity.

DRA also suggests SBC establish a monitoring and reporting system to evaluate whether disability related improvements are implemented effectively and timely, with review of customer service satisfaction levels from consumers with disabilities. The report would also include a comparison of customer satisfaction levels pre and post merger, to ensure that the overall level of customer satisfaction among customers with disabilities does not decline.

DRA recommends that some portion of § 854 (b) merger benefits be used to establish grants aimed at providing telecommunications access to underserved communities, with programs specifically targeted to reach the disability community. DRA suggests that the funding could be administered through an existing telecommunications foundation with a portion of the fund designated for disability related issues. As other alternatives, DRA suggests establishing a new foundation aimed at closing the digital divide and providing access to telecommunications services generally, or contributing to an existing fund, such as the DRA Fund, a donor-advised fund administered by the San Francisco Foundation, with directions to fund programs to increase the accessibility and availability of telecommunications technology.

Community Technology Foundation of California (CTFC) proposes that a minimum of $100 million (on a net present value basis) be allocated to a community benefit fund targeted toward the underserved community. CTFC defines "underserved communities" as including low-income, inner-city, minority, disabled, and limited English-speaking community sectors who lack equal access to basic and advanced telecommunications infrastructure and services.

5. The Settlement Between Greenlining, LIF, and Applicants

Greenlining, LIF, and SBC entered into a settlement agreement regarding the issues raised by Greenlining in this proceeding. The terms of the proposed settlement were first provided to parties and the Commission concurrently with opening briefs (attached as Exhibit A to the Greenlining Brief). The settlement provides a set of commitments by Applicants that purport to satisfy the requirements of §§ 854(b) and (c) relating to net benefits to consumers, including underserved communities.

The three main commitments presented in the settlement relate to:

a. increased supplier diversity commitments consistent with this Commission's General Order (GO)-156 goals;

b. increased access by underserved communities to advanced technologies; and

c. increased philanthropy commitments to underserved communities.

As one of the prongs of the settlement, SBC commits to raise its corporate and foundation philanthropic contributions in California from $6.6 million a year to $15 million a year for two years beginning in 2006 (assuming merger approval) and to $20 million a year for the subsequent three years or until 2010. As part of this long-term commitment, SBC has pledged to ensure that at least 60% of such philanthropy is directed at underserved communities.

The overall § 854(b) benefits through the settlement, just through the philanthropy portion, are $57 million over five years. The $57 million figure is based upon SBC's corporate and foundation giving in 2004, which represented $6.6 million a year. The philanthropic commitment in the settlement agreement is $90 million over five years, or an increase of $57 million.

SBC commits to direct at least 60% of these benefits toward underserved communities. Greenlining argues that this commitment is greater than the typical corporate commitment and greater than the percentage of the population that is considered underserved.

Greenlining believes that because SBC's commitment is part of a long-term strategic plan, it is likely to have a greater impact than dollars committed by government, most foundations, or by corporations without long-term philanthropic commitments.

In terms of supplier diversity, SBC commits to achieving 25% minority supplier diversity by 2006 and 27% by 2010. Using its base for 2004 of 23%, Greenlining estimates that additional minority supplier diversity spending in California in 2006 could grow to $40 million, and by 2010, to $80 million a year.

Assuming a midpoint figure of 26%, Greenlining estimates that over five years, additional minority supplier diversity spending could grow to $300 million.

As another element of the settlement, SBC agrees to actively participate in the creation of "a statewide broadband taskforce, a public-private partnership focused on addressing California's digital divide." Greenlining argues that the value of this commitment could be considerable and have the potential, assuming cooperation from the CPUC, the legislature, high technology corporations, and the leadership of the CEO of SBC, to be even more valuable to underserved communities than § 854(b) benefits from philanthropy and supplier diversity.

Greenlining argues that this additional $57 million in philanthropic commitments constitutes a § 854(b) benefit. In evaluating the dollar amount of the § 854(b) requirements imposed on SBC, Greenlining urges that, at a minimum, this $57 million should be credited against any § 854(b) benefits; and be considered substantially more valuable than unleveraged refunds to all telecommunications consumers.

Greenlining calculates that the $57 million over five years in refunds to 10 million customers would constitute the equivalent of only 10 cents a month per customer. Greenlining also urges that the § 854(b) benefits be examined in the context of typical government, foundation, or corporate grants. Government grants, replete with bureaucracy and political motivation, frequently involve little long-term planning or strategy. Corporate grants, particularly when made from year to year, lack long-term strategic objectives and most corporations contribute 20% or less of their philanthropy to underserved communities. And in regard to foundations, the vast majority of foundation funding to underserved communities ignores the minority community. (The national average for foundation giving is 2% to African American communities, 1% to Latino communities, and one-third of 1% to Asian American communities).

6. Responses to the Settlement

ORA and TURN argue that the Commission should not approve this settlement at this time because the settlement has not been subject to scrutiny by other parties as required by the Commission's Rules of Practice and Procedure ("Rules"). The settlement proposes to resolve issues now that ORA and TURN have asked to be deferred to a subsequent phase of this proceeding, after the total amount of shared benefits has been determined.

The Commission's Rules require that all parties have an opportunity to review and comment on settlements. Rule 51.1(b) specifically requires that prior to the signing of a stipulation or settlement, the settling parties shall convene at least one conference with notice and opportunity to participate provided to all parties for the purpose of discussing stipulations and settlements in a given proceeding. Notice served in accordance with Rules 2.3 and 2.3.1 of the date, time, and place shall be furnished at least seven (7) days in advance to all parties to the proceeding.

This requirement has not been met. The Rules also provide for an opportunity to comment on the settlement. ORA believes this comment process should occur in a second phase of this proceeding, once the amount of economic benefits to be shared with ratepayers has been established.

In its Opening Brief, Greenlining asks that the additional amounts of corporate philanthropy required under the settlement be credited against any § 854(b) benefits allocated by the Commission. Greenlining asserts that allocating these benefits per the settlement agreement would be more beneficial than making refunds to customers. ORA does not believe the settlement is clear as to what extent ratepayers would actually benefit. The settlement would establish a Broadband Taskforce, yet such a body is already contemplated by the Commission's recent rulemaking on advanced technologies, R.03-04-003. In that proceeding, the Commission issued a broadband report which, among other things, made clear its expectations that the ILECs would play an active role in its efforts.[223]. Therefore, it is unclear what additional effort or value this portion of the settlement represents as compared to the status quo.

The settlement also calls for SBC to increase its charitable giving, using monies that otherwise would be shared as merger benefits. SBC California's dues donations, and advocacy expenses have traditionally been booked "below the line" in accordance with established ratemaking theory. *GTE California* (*NRF Review*) (1994) 55 Cal. P.U.C. 2d 1, 41-42. Provisions on service quality also seem to duplicate the Commission's requirements.

The provision of the settlement relating to philanthropy also protects SBC shareholders by affirming that SBC "pays no financial price for its philanthropic leadership" should the merger not go through, or if it only gains approval subject to "onerous conditions." The settlement fails to clarify how "onerous conditions" would be defined. Presumably, if any conditions are imposed with which Applicants view as "onerous," any funding of philanthropy commitments under the settlement would be charged to ratepayers. Yet, the Commission has repeatedly affirmed its prohibition on using ratepayer funds to cover expenses associated with philanthropy.

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[223] D.05-05-013, Appendix A, p. 77.

TURN also raises questions about the basis for the claim that the settlement results in an increase in $57 million in philanthropic giving. TURN points out that in order for the $57 million commitment to be meaningful, there should be a comparison against pre-merger levels of giving, not just for SBC but also for AT&T's California operations. Otherwise, SBC could reduce AT&T's level of donation to offset the increased donations by SBC California. TURN also notes that no basis has been provided for finding that 2004 donations are an appropriate benchmark for assessing the significance of the $57 million figure as a commitment of increased giving levels. Likewise, there has been no showing as to whether, or by how much, SBC may have increased its philanthropic contributions absent the merger. Only the portion of philanthropy that would not have occurred absent the merger can be properly attributed as a merger benefit.

The settlement is further constrained only by a "good faith" goal that 60% of the new incremental spending will go to "underserved communities or to nonprofits whose primary mission is to serve underserved communities, minorities, or the poor." That means that up to 40% of the funding could go to other charitable purposes having nothing to do with underserved communities. Moreover, there is no requirement that even the 60% earmarked for underserved communities be spent on activities related to improving the access of those communities to telecommunications or other information services.

DRA argues that philanthropy commitments, by themselves, are no substitute for ensuring accessibility of Applicants' programs and services to consumers with disabilities. DRA disagrees with the claim made in the settlement that philanthropy is likely to have a greater impact than funds committed by government and most foundations without long term philanthropic commitments. DRA notes that several parties testified that foundations created in past mergers serve as a model for the way benefits to ratepayers can be leveraged to benefit underserved communities.

With respect to the interests of consumers with disabilities, the Settlement would extend the life of the California Disability Advisory Group (DAG) until December 31, 2009, and expand it to include national issues and universal design. There is no provision in the Settlement, however, to ensure that the DAG's recommendations are reviewed by upper management so that they may be acted upon. Without this requirement, DRA is concerned that post-merger, the DAG will lack authority or audience to have its recommendations implemented.

TURN also points out that in order to measure the value of SBC's commitment with respect to supplier diversity, there needs to be some baseline regarding the company's goals absent the settlement. Otherwise, there is no way to assess the value of the promise, or to measure SBC's compliance therewith.

ORA argues that these requests ask for relief that is not appropriate at this time. Both ORA and TURN have asked that the Commission consider how § 854(b) benefits will be allocated *after* determining the amount of economic benefits that will be allocated to ratepayers. ORA has not argued that these benefits must necessarily be returned to ratepayers in the form of a refund or surcredit, but has asked the Commission to consider how to fund several of the conditions that ORA has proposed or supported.

The conditions proposed and supported by ORA are designed to have an overall benefit on ratepayers in California. They will either improve or maintain the competitive environment, improve service quality, or insulate ratepayers from the risks of this transaction, including increased rates. ORA believes the recommendations of the settlement should not be considered in isolation, but should be compared with other proposals to use allocated ratepayer benefits in the public interest. As a result, ORA believes the Commission should consider this settlement in a subsequent phase of this proceeding, once the amount of economic benefits to be shared with ratepayers has been established.

The settlement states the terms and conditions of the agreement will be "the equivalent of § 854(b) requirements."[224] ORA has asserted that the total economic benefits of this transaction lie in the range of $1.87 billion. ORA, therefore disputes the claim that an increase in charitable giving and other incremental refinements to SBC's business practices is "equivalent" to a proper 50% allocation to consumers of $1.87 billion in synergies.

7. Discussion

While the settlement extracts certain concessions from Applicants relating to philanthropy, diversity, and bridging the digital divide, other substantive and procedural defects prevent us from adopting the settlement in its present form. We agree with TURN and ORA that because settling parties failed to convene a settlement conference pursuant to Rule 51.1(b), the settlement is not ripe for Commission adoption. Nonetheless, to the extent that parties have commented on the settlement to a limited extent through reply briefs, they have identified various questions and concerns with the terms of the settlement.

Specifically, we have already determined the benefits that apply as a result of the synergy calculations discussed previously in this decision. We have also adopted other various mitigating conditions with which Applicants disagree.

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[224] Settlement Agreement, at p. 7.

Yet, the settlement would permit Applicants to abandon all of their commitments under the settlement if they unilaterally deemed other requirements of this decision to be "onerous." Such a condition would unacceptably foreclose the Commission from carrying out its responsibilities to make sure the proposed merger is in the public interest.

While the settlement, as a complete package, cannot be adopted in the form that sponsoring parties request, we do find that individual elements of the settlement contain useful information, particularly in the context of the larger body of testimony and evidence that parties have presented concerning diversity, charitable giving, and bridging the digital divide to underserved communities. Accordingly, we shall require Applicants to agree to the commitments set forth below in order to satisfy the public interest requirements under § 854(c.) The funds required to meet these commitments under § 854(c) are in addition to the synergy net benefits calculated pursuant to § 854(b), as discussed above.

With respect to supplier diversity, we shall require as a condition of the merger that Applicants commit to the minimum diversity goals set forth in the settlement. We conclude that these diversity goals will be instrumental in satisfying the requirements of § 854(c)

With respect to charitable giving, we shall adopt as a condition of the merger that SBC commit to the level of $57 million in additional philanthropic giving as discussed in the proposed setttlement. The settlement proposes that SBC make only a "good faith" commitment to allocate 60% of this increased philanthropy to underserved communities. Given the testimony served on the concerns of the underserved communities, we conclude that more specific commitments are needed beyond the limited terms of the settlement.

We shall require that at least 80% of the increased SBC philanthropy be reserved for the low-income, underserved disabled, and minority communities. The 80% level is consistent with the recommendation in the testimony of Greenlining prior to the settlement. We believe that each of the parties representing the various underserved sectors of the community have raised valid concerns as to the effects of the merger on these various sectors. The question remains as to how this finite pool of available funds can best be allocated among the needs of these different interests. Now that the total amount of available funds to address § 854(c)(6) concerns has been determined, parties will be in a more informed position to present proposals as to how these funds should be allocated. We shall therefore solicit comments from parties concerning more specific measures concerning how the philanthropic funds should be allocated among these various interest groups, with particular attention to the specific needs of disabled, low-income, minorities, and other elements of the underserved community, as part of our consideration of the distribution of net benefits. As part of their comments, parties should address the extent to which the funds should be allocated in the form of grants to community-based foundations. Comments shall be due 20 calendar days after the effective date of this decision. Following review of those comments, we shall determine further direction regarding the use and distribution of the additional SBC philanthropy commitments.

We find that this condition will help to assure the merger will benefit local communities and economies in accordance with § 854(c), while fulfilling this Commission's mandate to pursue widespread availability of high-quality telecommunications services to all Californians under § 709 of the Public Utilities Code.

F. Effects on Quality of Service

Pub. Util. Code § 854(c)(2) mandates that the Commission consider, in its evaluation of a merger proposal, whether the merger maintains or improves service to public utility ratepayers in the state. Applicants are not able to engage in detailed planning until the transaction closes, but anticipate that the integration of AT&T's national and global IP network with SBC's in-region data network will create efficiencies that improve service quality for IP-based services. AT&T has experienced a declining credit rating and seen declining capital investment.[225] The merger will address this problem, thereby allowing for increased expenditures to develop advanced technologies and services. Applicants claim that the merged company's technology deployment and innovation will result in service quality at least being maintained or improved for California.

TURN raises the concern that merger-related workforce reductions and system consolidation will increase the risk of harm to service quality in California, particularly in the short run. Service quality reductions may affect some types of customers more than others. Applicants, for example, may be able to exploit merger-related increases in market concentration to cut back on service quality for low-revenue, basic service customers.[226] In areas with few competitive options, Applicants would have an incentive to cut back on maintenance of basic services and divert resources to more profitable services, such as broadband build out. To the extent the merger increases the incentive for

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[225] Polumbo (JAs) Ex. 15, p. 19; Kientzle (TURN) Ex. 135 at Ex. ERYK-4.

[226] Ex. 136C, Murray Testimony, pp. 127-128

capital spending, the adverse effects of such an incentive to redirect priorities would be heightened.

ORA proposes that SBC be required to maintain its 2001 level of service quality in the areas in which it exceeds or is statistically indistinguishable from the industry standard (reference group) established in D.03-10-088 (the NRF Phase 2 B Service Quality Decision).[227] ORA proposes that the merged company be required to improve service quality in those areas identified in the Phase 2B decision in which its performance was significantly worse than the industry standard. When customers suffer service outages, ORA argues, they should be compensated more than the pro rata share of their monthly charges. (Ex. 26C, p. 72, ORA / Piiru.) ORA proposes remedies for poor service quality. (Ex. 26C, pp. 77, 81-82, ORA / Piiru.)

ORA proposes that SBC California be required to meet national standards within two years after a decision is rendered approving the merger. ORA favors extending this requirement for ten years after a decision is rendered approving the merger, unless stricter standards are adopted before then. ORA argues that failure to meet the target level of performance for any of the ARMIS 35-05 measures, as described above, including those for which SBC CA equaled or exceeded the reference group, should constitute a violation of the conditions of the decision approving this merger, with concomitant penalties.

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[227] The Phase 2B Decision identified the major LECs (reference group) used to compare performance on ARMIS service quality measures with SBC. The Phase 2B Decision found that SBC California performed significantly worse than the reference group on Residential Initial and Repeat Out of Service Intervals and on Residential Initial and Repeat All Other Repair Intervals.

ORA argues that until advanced capabilities are developed and used in the merged company to improve service quality where it is currently weak, SBC CA should perform at least to the level of the rest of the industry on those measures. The Phase 2B Decision identified the major LECs (reference group) used to compare performance on ARMIS service quality measures with SBC. The Phase 2B Decision found that SBC California performed significantly worse than the reference group on Residential Initial and Repeat Out of Service Intervals and on Residential Initial and Repeat All Other Repair Intervals.

In the SBC/Telesis merger, SBC provided certain assurances that service quality would be maintained or improved, although SBC's repair service subsequently deteriorated. ORA states that the merged company also engaged in unscrupulous and illegal customer practices. ORA argues therefore that the Commission should hold SBC to its claims concerning service quality standards.

We shall require Applicants, at a minimum, to maintain the 2001 level of service performance in those areas where SBC exceeds or is indistinguishable from the industry standards established in D.03-10-088 (the NRF Phase 2 Service Quality Decision). We shall also require Applicants to improve service quality to the level of the industry standard in those areas where SBC was found to perform below industry standards. These requirements shall apply for a period of no less than five years or until the Commission changes those standards. In particular, Applicants shall maintain the quality of service to low-revenue basic service customers.

ORA has also proposed certain modifications to existing service quality standards in different areas. While we do not minimize the importance of service quality in the areas presented in ORA's analysis, we are not convinced that this merger proceeding is the appropriate forum in which to address such modifications in service quality standards, even if some rule revisions may ultimately be in order.

G. Commission's Ability to Regulate and Audit Public Utility Operations in California

1. Separate Affiliate Accounting Rules

ORA argues that the merger will increase the risk of cost misallocation, cross-subsidization, and discriminatory treatment by SBC as a result of its acquisition of AT&T's facilities. ORA argues that the merger will create a fundamental change in the conduct of SBC's long distance operations, and without mitigating conditions, will adversely impact the ability of this Commission to effectively regulate and audit SBC's utility operations in California. Whereas today SBC provides long distance service by purchasing capacity from long distance wholesalers and reselling it to their local service customers, the post-merger SBC will presumably seek to operate its own (formerly AT&T-owned) long-haul facilities on an integrated basis with its own operations, and to self-provide long distance service over the AT&T network.

Up until now, SBC has had to pay for wholesale long distance capacity to a third-party vendor. This wholesale arrangement limited the opportunities for SBC to engage in anticompetitive conduct and cost shifting by significantly limiting the number of services and facilities of its own for providing long distance service.

TURN likewise raises concerns that the merger would add to the complexity of SBC's affiliate transactions, which already are difficult to regulate and audit. TURN believes this concern is heightened because SBC has previously expressed opposition to further comprehensive audits.[228]

TURN further argues that the Commission's ability to regulate effectively will be impacted by the elimination of AT&T as an independent voice of competition in regulatory proceedings before the Commission. AT&T, along with MCI, has been distinguished by its considerable resources to monitor and participate in a broad range of Commission telecommunications proceedings. TURN is concerned that the elimination of AT&T will create a significant void in the deliberative process, particularly in complex dockets involving cost models put forth by SBC and Verizon.[229]

ORA thus proposes reviving provisions of Section 271 and 272 of the 1996 Telecommunications Act, and also in Public Utilities Code Section 709.2(c) relating to (1) conduct requirements applicable to separate affiliates and their relationship to SBC ILEC operations and (2) requirements for separate accounting records to prevent improper cross subsidization of intrastate interexchange telecommunications services.

ORA raises concerns that the additional competitive advantages that SBC will gain from integrating its facilities will coincide with the scheduled automatic expiration of certain currently existing requirements under Section 272(f)(1) of the 1996 Telecommunications Act relating to separate affiliate activities. Section 272 required the RBOCs initially to operate their long distance services out of a separate affiliate that transacts business with the ILEC on an "arms-length" basis.

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[228] Ex. 136C, Murray Testimony, Ex. TLM-2, SBC Response to TURN 6-17.

[229] Ex. 136C, Murray Testimony, p. 131.

The Section 272 requirement for SBC to use of separate affiliates for its long distance business is scheduled to expire automatically by October 2006 unless the FCC takes affirmative action to extend the requirement for a longer period. ORA expresses concern that if the automatic expiration takes effect, SBC will no longer be subject to any competitive safeguards with respect to the joint operation of their local and long distance businesses. ORA argues that without these safeguards, the post-merger integration of SBC/AT&T operations will make it very difficult for state commissions and other regulatory bodies to set rates and allocate costs. Accordingly, as a condition of the merger, ORA thus proposes reviving provisions of Section 271 and 272 of the 1996 Telecommunications Act, and also in Public Utilities Code Section 709.2(c) relating to (1) conduct requirements applicable to separate affiliates and their relationship to SBC ILEC operations and (2) requirements for separate accounting records to prevent improper cross subsidization of intrastate interexchange telecommunications services. These provisions are due to expire in 2006.

Applicants oppose this recommendation, arguing that the proposal does not address any issue directly related to the merger, or any adverse consequences therefrom. Applicants claim that ORA has failed to establish any underlying problem related to the merger requiring mitigation.

We agree that ORA raises a valid concern regarding the ability of the Commission to effectively regulate the merged entity as required under § 854(c.)(7). Applicants have not provided a convincing argument show that ORA's concerns are unfounded or unrelated to the merger. If the separate affiliate requirements of Section 272 are allowed to expire in October 2006, the post-merger integration of SBC/AT&T operations will make it very difficult for state commissions and other regulatory bodies to set rates and allocate costs. The merged entity would not be subject to any regulatory oversight of its ownership of its combined facilities, making it virtually impossible to detect and prevent cost misallocation, cross-subsidization, and discrimination favoring the merged entities services at the expense of customers. ORA witness Tan indicates that, as revealed in the most recent staff NRF audit, internal control relating to SBC-California and its affiliate transactions was found to be inadequate. Moreover, SBC California has been paying several layers of fees to its parent and affiliates since SBC acquired Pacific Telesis, and its payments to affiliates for services have grown substantially. ORA is concerned that if such a pattern continues, it could lead to a dangerous drain on capital needed for California's own telecommunications infrastructure. The merger makes this concern more significant because of the effects of combining AT&T and SBC facilities under one holding company, as explained by ORA.

Thus, we shall impose as a condition of the merger that SBC continue to maintain the separate affiliate requirements of Section 272 beyond the date that they are scheduled to automatically expire. We shall require that these requirements be extended for an additional three year period beyond the effective date of this decision. After this additional three year period has elapsed, parties may file a formal petition for extension of the requirements for a longer period if they believe conditions at that time so warrant.

2. ORA Proposed Condition Relating to Imputation Rules

As an another mitigation measure, ORA proposes that additional price imputation conditions be imposed. ORA witness Selwyn testified that unless or until the retail competition for local and long distance services previously offered by AT&T (as well as MCI) is replaced, the potential exists for significant price increases by SBC. To address this risk, Selwyn proposes that additional price imputation rules be imposed beyond those currently required under Section 272(e) of the 1996 Act. Section 272(e)(3) requires that SBC impute into its own long distance prices the same SBC access charges that would be paid by rival carriers.

Theoretically, SBC / AT&T should be indifferent between providing long distance service to an SBC ILEC customer or to a customer of a different LEC where actual cash payments for access would be required. In fact, however, SBC has chosen not to market is long distances service to customers of other LECs. ORA witness Selwyn argues that SBC's behavior in this regard underscores the need for an imputation requirement to prevent discrimination.

Selwyn believes that existing imputation rules under Section 272(e) are too general in nature to fully address the potential for discriminatory pricing as a result of the SBC / AT&T merger. For example, the issues of exactly what should be "imputed" has been very controversial. Selwyn thus proposes that more effective imputation rules need to be imposed. As a basis for ORA's recommendation on imputation rules as a condition of this merger, Selwyn draws upon an an *ex parte* filing made in June 2004 in WC Docket No. 02-112 by AT&T. In this filing, AT&T addressed the inability of existing imputation rules to adequately prevent the RBOCs from subjecting rivals to a price squeeze by simultaneously imposing high access charges while setting retail prices that fail to reflect those same access charge levels. AT&T proposed a specific, and detailed, set of imputation rules intended to limit the RBOCs' ability and opportunity to impose these types of price squeezes on their rivals.[230] A copy of AT&T's proposed Imputation Rule is set forth as Attachment 4 to Selwyn's testimony.

Applicants object to any additional imputation rules, and argue that ORA has failed to show that its proposal is direct result of the merger. Applicants believe that existing imputation rules are sufficient.

ORA raises a valid concern regarding the effects the merger will have on the ability of SBC/AT&T to engage in discriminatory behavior. The increased market power from the merger will cause the potential risk of competitive harm from such behavior to be greater. The imputation rules proposed by ORA provides a more effective means to address this concern than is currently available through Sec. 272. Accordingly, we shall adopt ORA's proposed condition to impose the imputation rules set forth in Attachment 4 to Selwyn's testimony.

Selwyn argues that a strictly enforced imputation regime is critical to the development of competition, and should be retained until such time as sufficient *and ubiquitously deployed* alternative *facilities-based* competition capable of supporting services *in the same product market* as wireline telephone service comes into existence. We shall direct that these conditions remain in place for a five year period from the date of this decision. If any party believes conditions at that

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[230] *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, *2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules*, CC Docket No. 00-175 ("*Non-Dominant Proceeding*"), Ex Parte Declaration of Lee L. Selwyn and Covering Letter of AT&T, filed June 9, 2004.

time warrant a further extension of the requirement, the party may file a petition seeking such extension.

3. Third-Party Monitoring of Competitive Conditions

TURN proposes that, as a condition of approving the merger, that Applicants fund third-party monitoring of competitive conditions in California, with particular emphasis on how effectively competition is constraining the prices, terms, and conditions under which SBC offers service to various customer segments. TURN also proposes that Applicants' corporate affiliates be required to cooperate fully with the third-party monitor to provide all information necessary to ascertain the degree to which competitive losses for SBC's public utility operations in California are attributable to competitive gains by affiliates. TURN witness Murray set forth further detail in Appendix B of her testimony concerning the manner in which the monitoring of competition should be implemented. TURN suggests that a workshop forum be used to develop the specific survey approach and requirements to maximize the usefulness of the third-party monitoring product.

TURN argues the results of such monitoring would be of great value to the Commission in confirming whether, or to what extent, a competitive market actually develops over time, and whether competition is producing an equitable distribution of options and information for all consumer groups. Such monitoring would also provide advance warning if competition is failing to deliver anticipated benefits or failing to develop at all.

Applicants object to this condition, arguing that it does not address any issue directly related to the merger, or any adverse consequences of the merger.

Applicants claim that TURN has failed to establish any underlying problem related to the merger requiring this measure as mitigation.

We conclude that third-party monitoring of the progress of competitive conditions within the various market segments in which the merged entity offers service is an appropriate condition. As previously noted, the markets in California in which SBC operates are not sufficiently competitive today to approve the merger without conditions. It is hoped that competition will grow over time to curb the market power of the merged company. Without independent monitoring of competition, however, the Commission will have no way of determining whether competition actually develops over time within the markets in which the merged company operates. We have adopted mitigating measures in this decision to continue only for a limited period of time. Without an independent monitoring process, there will be no empirical verification of the extent to which mitigating conditions adopted in this decision may no longer be needed after the expiration dates established in this decision.

Accordingly, to provide for the necessary information for the Commission to make informed decisions in the future about the extent to which mitigating measures remain necessary to protect the public interest, we shall adopt TURN's proposal for third-party monitoring of competition. Applicants' corporate affiliates shall be required to cooperate fully with the third-party monitor to provide all information necessary to ascertain the degree to which competitive losses for SBC's public utility operations in California are attributable to competitive gains by affiliates. We shall adopt TURN's proposal to convene a workshop as an initial step through which all interested groups may participate in developing the procedures and details whereby effective independent third party monitoring of competition can be effectively developed and implemented. We direct the ALJ to schedule a workshop for this purpose.

VI. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Thomas R. Pulsifer is the assigned ALJ in this proceeding.

VII. Comments on the Proposed Decision

The proposed decision (PD) of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on ____________ and reply comments were filed on ______________.

Findings of Fact

1. Applicants seek approval of a transfer of control of AT&T Communications of California, TCG Los Angeles, Inc., TCG San Diego, and TCG San Francisco from first- and second-tier subsidiaries of AT&T to second and second- and-third-tier subsidiaries of the combined organization that will result from AT&T's planned merger with SBC.

2. As a result of the merger between SBC and AT&T, Applicants intend to strengthen the financial position of the combined company and improve its competitive position by combining complementary strengths and skills.

3. The California Attorney General filed his Advisory Opinion pursuant to § 854(b)(3) on July 22, 2005.

4. The Commission examines merger, acquisition, or control activities on a case-by-case basis to determine the applicability of § 854.

5. Applicants concede that § 854(a) applies to this transaction, but challenge the applicability of § 854(b) and (c).

6. Although the proposed merger transaction is technically structured as a merger between the holding companies of SBC and AT&T, the practical result of the merger will have effects on the California utilities that are owned by SBC and AT&T, respectively.

7. In determining whether SBC California is a party within the meaning of Section 854, the Commission focuses on substance rather than form.

8. It would elevate form over substance to find that § 854(b) and (c) do not apply to this transaction merely because Applicants designed the merger using a holding company structure.

9. It would elevate form over substance to conclude that the Legislature was more concerned with competition if the utility was a party to the transaction absent the holding company structure, but was less concerned about competition when a holding company was involved.

10. At the direction of the Assigned Commissioner, Applicants produced a calculation of net synergy benefits to California consumers on a discounted net present value basis, assuming the Commission applies § 854(b) to this transaction over Applicants' objections.

11. Applicants' calculated $14 million in net benefits to California consumers assuming the Commission were to find that § 854(b) applies. The $14 million represents 50% of the discounted net present value of Applicants' five-year forecast of merger synergies attributable to California, or approximately 2/10 of 1% of the total corporate synergies that Applicants forecast from the SBC/AT&T merger.

12. ORA and TURN performed separate calculations using Applicants' synergies model as a starting point. ORA produced a calculation of approximately $1.84 billion in applicable net synergy benefits to California on a

discounted net present value basis. TURN produced a calculation of approximately $1.98 billion. ORA and TURN each propose allocating 50% of the calculated net benefits to consumers.

13. The two largest factors accounting for the difference between the ORA/TURN calculation of synergies versus that of Applicants is due to: (1) inclusion of SBC California operations in the allocation and (2) extending the measurement period to incorporate the full period over which total corporate benefits were considered as a basis for shareholders' evaluation of the merger.

14. Based upon the calculations of synergies performed by Applicants, modified to incorporate certain adjustments made by ORA/TURN, the total net synergy benefits reasonably attributable to California is $659.2 Million on a discounted net present value basis under the provisions of Section 854(b).

15. A $329.6 million allocation of net benefits to California consumers represents a 50% share of total benefits of $659.2 million attributable to California, reflecting a six-year forecast period and taking into account the operations of both SBC and AT&T.

16. The adopted net benefit amount incorporates ORA's recommendation to reallocate offsetting costs to implement the merger so that a pro rata share are assigned beyond the period during which ratepayers share in the forecasted synergies.

17. The adopted net benefits incorporates the other miscellaneous adjustments that ORA and TURN have made to the net benefits calculation, except for Wiltel contract termination, investment banking fees, and CallVantage revenues.

18. Defining the "long term" in this proceeding as six years permits reasonable forecasts of economic benefits of the merger and also recognizes the rapid pace of change in the telecommunications marketplace.

19. The Attorney General's Advisory Opinion concluded that the merger will not adversely affect competition in California telecommunications markets with the exception of the market for special access. The Attorney General's Opinion concluded that the merger could affect competition in the market for private network special access, and proposed as a mitigating condition, a one-year freeze on rates paid by current AT&T customers receiving DS1 and DS3 private network services.

20. By focusing its analysis on facilities-based competition, the Attorney General's Advisory Opinion did not fully address the effects of the merger on the overall telecommunications markets in which SBC and AT&T compete. In this respect, the testimony presented by expert witnesses on competitive impacts of the merger provided a more complete analysis with respect to the range of relevant markets.

21. In D.91-05-028, the Commission set forth analytical precedents for interpreting whether a party's proposal "adversely affects competition" within the meaning of § 854(b)(3). The Commission held that precedent developed under Section 7 of the Clayton Act provides a framework for analyzing the competitive effects under § 854(b)(3).

22. The goal of analyzing the competitive effects of the merger is to protect consumers by preventing transactions likely to result in increased prices or reduced output. Mergers can harm consumers when they cause structural changes to the marketplace that increase a firm's ability to exercise market power, defined as the ability to affect prices or reduce output of the industry.

23. Under traditional market analysis, the market power resulting from the merger of two competitors is usually measured in terms of concentration, or

market shared. This is a statistical analysis using the Herfinhdahl-Herschman Index (HHI) which calculates the sum of the squares of each firm's market share.

24. The analysis of market share and HHI measures is a necessary starting point for analyzing market power due to a merger, after which additional indicators of prospective competition are properly considered.

25. Traditionally, the competitive effects of a proposed merger are analyzed by identifying the relevant product markets affected by the merger. The geographic scope of the market, the area in which the sellers compete and in which buyers can practicably turn for supply are identified as part of this analysis.

26. The relevant markets for purposes of analyzing the competitive effects of this merger include retail markets (i.e., mass market, medium and large enterprise customers) and wholesale markets.

27. Applicants did not perform an analysis of market concentration relating to this merger, either in the aggregate or for individual markets, since they believe that only forward-looking indicators of competition are meaningful in assessing the SBC/AT&T merger.

28. ORA and TURN witnesses presented calculations of the HHI with respect to individual market segments. This analysis showed that the HHI was already highly concentrated before the merger, and becomes more highly concentrated as a result of the AT&T acquisition.

29. Although the mass market is already highly concentrated, SBC's acquisition of AT&T will not significantly change the degree of mass market concentration since AT&T had already ceased actively marketing to this sector before entering into the merger.

30. Mass market customers could be adversely affected by the merger to the extent that merger-related costs could increase their utility bills, or utility resources could be diverted to reduce the level or quality of service offered to them.

31. SBC and AT&T chose to merge rather than to compete against each other through facilities-based expansion of their respective networks.

32. Given the failure of AT&T to succeed as an independent competitor pursuing facilities-based expansion, the prospects for other carriers with less financial resources to compete successfully against the post-merger SBC is called into question.

33. In the retail business markets and in wholesale markets in which SBC and AT&T compete, the measures of market concentration measured by the HHI indicates a material increase in SBC's market power from the merger.

34. Evidence presented concerning forward-looking measures of competition in sectors other than the mass market does not paint a picture of a robustly competitive market today or in the immediate future.

35. Although some competition from intermodal sources such as cable, VoIP, and wireless technologies exists within certain sectors of the SBC California service territory, such competition is not ubiquitous nor sufficiently developed in all relevant markets today to avoid the need for conditions to mitigate SBC's increased market power from the merger.

36. Although their marketing focus differs to some degree, SBC and AT&T have been competing head-to-head for enterprise business customers throughout the SBC footprint.

37. Certain proposed measures, as identified below, will mitigate the competitive harm that could otherwise result from the proposed merger.

38. Capping UNE rates in the manner proposed by CALTEL would undermine the TRRO policy with respect to those UNE provisioned under Section 251 for which TELRIC-based pricing has been eliminated. On the other hand, for those UNEs for which TELRIC-based pricing was not eliminated by the TRRO, the CALTEL price cap proposal is an appropriate remedy to mitigate the resource imbalance between SBC and its competitors. Commission-imposed price caps on those UNEs provisioned under Section 271 could conflict with broader FCC “just-and-reasonable” principles relating to the pricing of such UNEs.

39. CALTEL’s proposal is an appropriate mitigation measure seeking to permit carriers to opt in on any agreement negotiated by SBC in another state or any provision(s) arbitrated in California

40. SBC possesses significant market power in the provision of special access services in California.

41. AT&T has played a pivotal role in disciplining the rates, terms, and conditions under which SBC offers special access generally, both as an alternative source of supply to other competitors and by its negotiating leverage in obtaining more favorable terms and rates.

42. Absent mitigating conditions, the removal of AT&T as a competitor in the special access market will give SBC additional opportunities to leverage its market power against competitors to the detriment of consumers.

43. A reasonable mitigating condition on special access is that SBC be required to disclose publicly transactions between SBC and AT&T affiliates, and that the same complete package of terms and conditions be offered to competing carriers.

44. An additional reasonable mitigating condition on special access is that SBC be required to make available to carriers the lowest rate available from SBC or AT&T.

45. Parties' proposed condition to permit a "fresh look" period following the close of the merger has not been shown to be justified except for the limited purpose of allowing carriers to accept the same package of terms and rates negotiated between affiliates of SBC.

46. In order to facilitate network efficiencies and to mitigate the uncertainties as to how the post-merger environment will stabilize, a reasonable merger condition is for SBC to be required to offer transit at cost-based rates.

47. It is reasonable as a mitigation measure in response to AT&T's elimination as a competitor in the short-haul market, to require that AT&T extend its existing transport agreements for a five-year period at the same rates, terms and conditions.

48. Level 3 has not shown that Commission intervention is warranted in calling for the exchange of VoIP traffic at reciprocal compensation rates.

49. Applying numbering resource allocation rules to SBC and AT&T as a single entity is a reasonable requirement to enhance efficient utilization of number resources among carriers.

50. SBC's practice of refusing to offer standalone DSL service harms competition by making it more difficult for competitors to provide voice service to customers subscribing to broadband Internet access over SBC's DSL facilities. The potential harm from this practice will increase through acquisition of AT&T.

51. A reasonable merger mitigation measure is to require SBC to offer DSL on a stand-alone basis.

52. In order to mitigate the potential for SBC to engage in discriminatory arrangements with Verizon, a reasonable condition is to prohibit SBC from engaging in reciprocal arrangements with SBC for more favorable access than either company offers to other competitors.

53. Parties have not justified the proposed condition requiring divestiture of AT&T facilities given the potential adverse impact on customers and the administrative complexities that would be involved in implementing such a requirement.

54. In order to mitigate the adverse competitive merger impacts resulting from SBC's accelerated conversion from a circuit switched to a packet switched network, the Pac-West proposal is reasonable calling for SBC to consent to include packet-switched networks within the scope of arbitration proceedings conducted by this Commission pursuant to Section 252.

55. With the conditions as adopted in this decision, the merger will improve the financial condition of SBC and AT&T.

56. The merger will maintain or improve the quality of management of the combined company.

57. Service quality will be maintained or improved as a result of the merger, with the service quality conditions adopted in the ordering paragraphs below.

58. The merger will be fair and reasonable to affected public utility shareholders, as reflected by the approval of the merger by 98% of AT&T's shareholders.

59. With the adoption of conditions set forth in this order, the Commission will preserve its jurisdiction and ability to regulate and audit public utility operations in the state.

60. Subject to adoption of the mitigating conditions relating to philanthropy, workplace diversity, and outreach to underserved segments of the community, as set forth in the ordering paragraphs below, the merger will be beneficial on an overall basis to state and local economies and to the communities served by the combined company.

61. Applicants entered into a settlement with Greenlining and LIF addressing the issues of net benefits to consumers, supplier diversity issues, and corporate philanthropic commitments to local communities.

62. While the terms of the settlement would result in greater commitments than Applicants otherwise propose to offer, the settlement, in total, is procedurally defective and contains unacceptable restrictions that would prevent the Commission from adopting it in its present form consistent with § 854.

63. A reasonable measure to assure that the proposed merger is in the public interest of local communities, including the underserved segments thereof, SBC should be required to commit to philanthropic contributions in the amount of $57 million over a five-year period. A minimum of 80% of such contributions should be reserved for addressing the service requirements of the underserved segments of communities in which SBC serves. SBC should also to commit to achieving the supplier diversity targets as described in the settlement with Greenlining and LIF.

64. The merger will create a fundamental change in the conduct of SBC's long distance operations, which without mitigating conditions, will adversely impact the ability of this Commission to effectively regulate and audit SBC's utility operations in California.

65. If the separate affiliate requirements of Section 272 are allowed to expire in October 2006, the post-merger integration of SBC/AT&T operations will make it

very difficult for state commissions and other regulatory bodies to set rates and allocate costs.

66. The "first-priority" condition proposed by ORA will help assure that regulated utility operations are not adversely affected by the parent company's diversion of funds to other purposes as part of the post-merger implementation.

67. Existing imputation rules under Section 272(e) are too general in nature to fully address the potential for discriminatory pricing as a result of the SBC/AT&T merger.

68. Existing imputation rules fail to adequately prevent SBC from subjecting rivals to a price squeeze by simultaneously imposing high access charges while setting retail prices that fail to reflect those same access charge levels.

69. The set of imputation rules proposed by ORA provide a more effective means to limit the ability and opportunity for SBC (post-merger) to impose these types of price squeezes on their rivals than is currently available through Section 272.

70. Without independent monitoring of competition, the Commission will have no way of determining whether competition actually develops over time within the markets in which the merged company operates.

71. An independent monitoring process is needed to provide empirical verification of the extent to which competition develops within the markets in which the merged company operates.

Conclusions of Law

1. Section 854(e) requires that the Applicants have the burden of proof by a preponderance of evidence to demonstrate that the requirements of § 854(b) and (c) are met.

2. In order to determine whether § 854(b) applies to this application, the actual language of the statute should first be examined. In examining the statute's language, decisionmakers should give the words of the statute their ordinary, everyday meaning. If the meaning is without ambiguity, doubt, or uncertainty, then the language controls. Only if the meaning of the words is not clear, decisionmakers should take the second step and refer to the legislative history.

3. The plain language of § 854(b) is clear, and applies where a utility of a specified financial size is a party to the proposed transaction.

4. Because the substance of the transaction should take precedence over its mere form, SBC California and AT&T California should both be considered as parties to this transaction in applying § 854(b).

5. Past mergers of telecommunications companies which were granted an exemption from review under § 854(b) and (c) are not analogous precedents for this transaction which involves consolidating the assets of the largest ILEC in California with those of its largest competitor in California.

6. Section 854(b) and (c) apply to this transaction.

7. Section 854(b) requires the Commission to allocate certain forecasted benefits to ratepayers which accrue as a result of the merger where it has ratemaking authority.

8. Section 854(b) requires that ratepayers be allocated a minimum 50% share of short-term and long-term economic benefits accruing as a result of the merger.

9. A reasonable estimate of long-term economic synergies accruing to California consumers under the merger consistent with § 854(b) is $329.6 million on a discounted net present value basis representing 50% of the total synergies of $659.2 million.

10. The Commission should require as a condition of the merger that SBC pass on to consumers the § 854(b) economic benefits associated with the merger as quantified in this decision.

11. An equal sharing of the economic benefits between consumers and shareholders measured over the long term, defined as a six-year period, is reasonable in this case and compliant with § 854(b).

12. The specific distribution and/or utilization of the § 854(b) net benefits among various consumer interests should be addressed in a subsequent order following opportunity for parties to file comments.

13. Section 854(b)(3) requires the Commission to find that Applicants' proposal does not adversely affect competition. In making this finding, the Commission is required to 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.

14. The Commission must determine the appropriate weight to give the Attorney General's Advisory Opinion, also taking into account the substantive evidence on competitive harm and proposed mitigation measures presented through expert witness testimony in the proceeding.

15. The Commission need not find a technical violation of the Clayton Act in order to deny a merger under § 854. The Commission may disapprove a transaction whole impacts are harmful, but less than "substantial" under the Clayton Act.

16. The proposed merger should not have an adverse effect on competition within the meaning of § 854.

17. In carrying out its obligation to evaluate potential adverse effects under § 854, the Commission should examine all relevant effects on California

consumers, even if a particular impact may involve services that are regulated by a federal agency.

18. In order to meet the § 854(b) standard that the proposed merger does not have an adverse effect on competition, conditions should be imposed as set forth in the ordering paragraphs below to mitigate competitive harms that would otherwise result from the transaction.

19. In order to support findings that this transaction meets § 854(c) public interest criteria, Applicants should implement the measures set forth below relating to each of the designated subsections thereof.

20. With the imposition of the conditions as set forth in the ordering paragraph below, the proposed transaction meets the requisite criteria under § 854(b) and (c), and should be approved subject to those conditions.

O R D E R

IT IS ORDERED that:

1. The application of SBC Communications, Inc. (SBC) and AT&T Corp. (AT&T) is hereby granted for approval of a transfer of control of AT&T Communications of California, TCG Los Angeles, Inc., TCG San Diego, and TCG San Francisco from first- and second-tier subsidiaries of AT&T to second and second- and-third-tier subsidiaries of the combined organization that will result from AT&T's planned merger with SBC, with the conditions as set forth herein.

2. Applicants shall notify the Commission in writing that the merger which is the subject of this application has been accomplished. The written notice shall be delivered to the Commission within five business days of the effective date of the merger.

3. SBC shall maintain a cap on basic residential and small business local exchange services, including 1 FR, 1 MR, 1 MB, and residential inside wire maintenance plans, to continue for a period of five years from the effective date of this decision. These services shall be made available to consumers on a stand-alone basis without any requirement to purchase other bundled services. The services shall be listed separately in SBC phone directories and in any advertising on web sites or through bill inserts. SBC shall retain a pricing option for California-jurisdictional long distance calling that does not have a minimum monthly fee.

4. SBC shall implement appropriate measures to distribute Section 854(b) net benefits in the amount of $329.6 million on a discounted net present value basis covering a six-year period. The specific measures to be implemented shall be determined through a subsequent Commission order following opportunity for parties to comment on the manner in which the Section 854(b) net benefits should be distributed and/or utilized for the benefit of consumers. Comments on this issue shall be filed 20 calendar days from the effective date of this decision.

5. As a condition of Commission approval, SBC shall implement the following measures to remain in effect for a five-year period from the effective date of this order.

a. SBC shall maintain price caps on network elements to be made available under Sections 251 to the extent that TELRIC-based requirements were not eliminated by the TRRO. No reduction shall be made for a productivity offset.

b. SBC shall be required to disclose publicly transactions between SBC and AT&T affiliates, and that the same complete package of terms and conditions be offered to competing carriers

c. SBC shall be required to make available to carriers the lowest rate for special access available from SBC or AT&T.

d. Rates paid by current SBC and AT&T customers receiving DS1 or DS3 special access service shall be capped.

e. SBC shall be required to honor existing Internet peering arrangements and to offer extensions, if requested, for up to five years.

f. SBC shall be required to allow any CLEC to adopt in California any agreement that SBC has negotiated in any other state (except for state-specific prices and performance standards), or any provision or set of interrelated provisions that SBC has included in an agreement as the result of arbitration in California.

g. SBC shall be required to offer transit of traffic at cost-based TELRIC rates

h. AT&T shall extend its existing transport agreements for a five-year period at the same rates, terms and conditions.

i. Numbering resource allocation rules shall be applied to SBC and AT&T as a single entity.

j. SBC shall offer DSL on a stand-alone basis without being tied to SBC voice service.

k SBC shall be prohibited from engaging in reciprocal arrangements with SBC for more favorable access than either company offers to other competitors.

l. SBC shall consent to include packet-switched networks within the scope of arbitration proceedings conducted by this Commission pursuant to Section 252.

m. In order to ensure that there is no discriminatory pricing between AT&T and SBC with respect to VoIP services, such transactions shall be conducted at arms length, publicly disclosed and the prices in that agreement offered to all other providers without regard for any volume or term discounts.

6. Applicants shall agree to the following conditions in order to satisfy the criteria under Section 854(c).

7. To provide assurance that the merger is beneficial to local communications pursuant to §854(b)(c), Applicants shall agree to an increased cumulative philanthropy commitment of $57 million over a five-year period, with a minimum of 80% of that commitment reserved for the low-income, underserved, minority, disabled sectors of its service territory. A more specific determination of how the philanthropy funds should be distributed, either among the affected groups, and/or through grants to community based foundations shall be made following opportunity for parties to comment. Comments on the issue of the appropriate distribution and/or utilization of the philanthropy funds shall be filed 20 calendar days from the effective date of this decision.

8. To provide assurance that the merger maintains or improves the financial condition of public utility operations, SBC shall be subject to a "first-priority" condition, as proposed by ORA. SBC shall accordingly give utility operations first priority preference over all competing potential recipients of capital resources necessary to ensure the utility's ability to maintain its quality of service.

9. As a condition of the merger, SBC shall continue to maintain the separate affiliate requirements of Section 272 for an additional three-year period. Beyond the date that those requirements are scheduled to automatically expire in 2006. After this additional three-year period has elapsed, parties may file a formal petition for extension of the requirements for a longer period if they believe conditions at that time so warrant.

10. As a condition of the merger, Applicants shall comply with the price imputation rules set forth in Attachment 4 to ORA Witness Selwyn's testimony.

11. To assure that the merger maintains or improve utility service quality, Applicants shall, at a minimum, maintain the 2001 level of service performance in those areas where SBC exceeds or is indistinguishable from the industry standards established in D.03-10-088 (the NRF Phase 2 Service Quality Decision). This requirement shall apply for a period of no less than five years or until the Commission changes those standards. Applicants shall maintain the quality of service, in particular, to low-revenue basic service customers. Applicants shall improve service quality to the level of the industry standard in those areas where SBC was found to perform below industry standards in D.03-10-088.

12. Applicants shall be required to implement a process of monitoring of competitive conditions within which they provide service to provide for the necessary information for the Commission to make informed decisions in the future about the extent to which SBC's market power may be curbed by competitive market forces.

13. The ALJ shall schedule a workshop to provide for input from interested parties as to the manner in which the process for the independent monitoring of competition should be designed and implemented.

14. Applicants shall file written notice with the Commission in this proceeding, served on all parties to this proceeding, of their agreement, evidenced by a resolution of their respective boards of directors, duly authenticated by a secretary or assistant secretary, to the conditions set forth in this decision. Failure of Applicants to file such notice pursuant to this order within 60 days of the effective date of this decision shall result in the lapse of the authority granted in this decision.

This order is effective today.

Dated ____________________, at San Francisco, California.

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