BEFORE THE
STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

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| **In the Matter of the Application of Verizon New Jersey Inc. For Approval (i) of a New Plan for an Alternative Form of Regulation and (ii) to Reclassify Multi-line Rate Regulated Business Service as Competitive Services, and Compliance Filing** : | BPU Docket No. TO01020095 |

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# INITIAL BRIEF ON BEHALF OF THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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**REDACTED VERSION**


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*"The future is already here. It's just unevenly distributed."*[1]

# I. INTRODUCTION AND SUMMARY

In this proceeding, the Board will make important decisions affecting the affordability of telecommunications service and the availability of competitive telecommunications choices for New Jersey's ratepayers. Before the Board are competing proposals for a new plan of alternative regulation ("PAR-2") by Verizon-NJ and the Ratepayer Advocate. In addition, Verizon-NJ requests that the Board deem competitive and deregulate all multi-line business services. The Ratepayer Advocate, on the other hand, proposes to spur local exchange competition, as well as prevent anti-competitive discrimination by structural separation of Verizon-NJ's retail and wholesale businesses or, in the alternative, promulgation of a code of conduct. The ultimate decision on each of these matters depends fundamentally on the state of telecommunications competition in New Jersey and the relationship between that competition and regulation by the Board.

This brief begins with a discussion of this central issue – the state of competition in New Jersey's telecommunications markets. *Infra* Section II. It then discusses the proposal by Verizon-NJ and the Ratepayer Advocate's superior proposal for a plan of alternative regulation, including a plan for universal service benefits. *Infra* Section III. The next section of the brief addresses Verizon-NJ's request for reclassification of multi-line business services in the face of stunted competition. *Infra* Section IV. Section V of the brief discusses the proposal for structural separation and the Ratepayer Advocate's alternative proposal of a program of functional/structural separation through a code of conduct.

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[1] T.49:14-15 (8/13/01) (Statement of Ratepayer Advocate Blossom A. Peretz, *quoting* William Gibson).

**Telecommunications Competition in New Jersey**

Verizon-NJ argues that sufficient competition has developed to merit virtual deregulation, but the facts belie Verizon-NJ's position. Verizon-NJ controls a dominant share of the local exchange market in New Jersey. *Infra* Section II. This position is barely threatened by would-be competitors, most of which are cash-strapped or in bankruptcy. *Id.* This Board has previously found that Verizon-NJ's control over the facilities necessary for effective competition are a major barrier to future competition. *Id.* The Ratepayer Advocate respectfully urges the Board to act on this finding by establishing a PAR that fully reflects Verizon-NJ's dominant position which will provide a pathway to a competitive marketplace. In addition, the Board should deny Verizon-NJ's request for reclassification of multi-line business services as competitive. Finally, the Ratepayer Advocate recommends that the Board order full structural separation or a strong code of conduct to give Verizon-NJ the proper incentives that promote retail telephone competition and CLECs the proper incentives to enter the New Jersey local exchange market.

**The PAR-2 Proposals**

This proceeding continues the course that the Board set eight years ago when it established the first plan for alternative regulation ("PAR-1"). *Application of New Jersey Bell Telephone Company for Approval of its Plan for an Alternative Form of Regulation, Decision and Order*, Docket No. TO92030358 (May 6, 1993) ("1993 Order"). The Board designed PAR-1 to promote competition in the local marketplace while protecting New Jersey's monopoly ratepayers with new regulatory approaches, including a rate cap, adjustments to rates to reflect cost changes and exogenous events, and earnings sharing (1993 Order at 33, 43-45). Par-1 served as the vehicle to regulate Verizon-NJ's conduct during the incubation of competition.

1993 Order Section III.E; *infra* Section III. Now, almost a decade after establishing PAR-1, the Board must update Verizon-NJ's alternative regulation plan within the existing framework to reflect the current climate.

In this proceeding, Verizon-NJ has tried to go beyond revisions and sought fundamental changes to the plan that would effectively erase the regulatory oversight, shielding the Company as much as possible from the Board's scrutiny. Verizon-NJ's original proposal would have explicitly deregulated *all* its retail services by classifying them as competitive. *I/M/O Application of Bell Atlantic-New Jersey, Inc., for Approval of a Modified Plan for an Alternative Form of Regulation and to Reclassify All Rate Regulated Services as Competitive Services*, Petition of Bell Atlantic-New Jersey Inc., Docket No. TO99120934 (December 30, 1999) ("CTP"). That wholly unsupported bid for the ability to exercise monopoly power unencumbered by regulation summarizes Verizon-NJ's goals in this proceeding.

The Verizon-NJ proposal now before the Board is only slightly more subtle in its effort to preserve Verizon-NJ's monopoly and escape meaningful regulation. Verizon-NJ proposes a radical departure from the principles of PAR-1. *I/M/O Application of Verizon New Jersey, Inc. for Approval (i) of a New Plan for an Alternative Form of Regulation and (ii) to Reclassify Multi-line Rate Regulated Business Services as Competitive Services, and Compliance Filing*, Petition and Compliance Filing of Verizon New Jersey, Inc., Docket No. TO01020095 (February 15, 2001) ("PAR-2 Petition"). Verizon-NJ would have the Board tacitly eliminate the rate cap, as well as earnings sharing and the productivity offset provisions that are fundamental to the current plan. *Infra* Sections III.A.1-2. In essence, Verizon-NJ asks to retain all the cost savings, merger savings and excess earnings that it would be forced to share with ratepayers in a competitive

market. In addition, Verizon-NJ proposes to eliminate the current plan's exogenous event and quarterly reporting provisions. Moreover, Verizon-NJ seeks to alter the procedures for establishing new services and restructuring rates, changes that would give Verizon-NJ unwarranted discretion to vary the prices and terms for regulated services and hamstring the Board in its efforts to achieve effective competition and regulation. *Infra* Sections III.A.3.-5. The proposal fails to satisfy the statutory criteria for a PAR, and the Board should reject it. *Infra* Section III.A.6.

In stark contrast to Verizon-NJ, the Ratepayer Advocate proposes revisions and updates within the framework of the current plan of alternative regulation to account for Verizon-NJ's dominant position and the possibility of future competition for Verizon-NJ. *Infra* Section III.A. The Ratepayer Advocate's proposed plan includes a rate cap that will protect consumers and continue to ensure affordable service, realize earnings sharing and provide for rate adjustments that will replicate the results that competition would bring about. *Infra* Section III.A.1. Verizon-NJ's proposal, to the contrary, would tacitly eliminate the rate cap, leaving Verizon-NJ free at any time to raise the rate for residential basic exchange service that the Board has so vigilantly protected over the years. *Id.* In effect, Verizon-NJ is attempting a departure from the Board's regulatory reach.

The absence of meaningful competition will continue to allow Verizon-NJ to amass excessive earnings that should be shared with ratepayers. *Infra* Section III.A.2. The Ratepayer Advocate's proposed plan would impose earnings sharing and a rate adjustment where Verizon-NJ's markets remain insulated from meaningful competition, and Verizon-NJ's service offerings would be completely deregulated when and if Verizon-NJ no longer has a dominant position. *Id*.

These regulatory mechanisms are calibrated to take into account the amount of competition facing Verizon-NJ; as competition increases, the amount that Verizon-NJ must share with ratepayers decreases. *Id.* This arrangement provides Verizon-NJ with incentives to operate more efficiently, and at the same time protects consumers against Verizon-NJ's exercise of monopoly power through excessive prices. *Id.*

In Section III.A.2., the Ratepayer Advocate explains the basis for the earnings sharing it proposes, and analyzes the proper method of measuring those earnings. There we demonstrate that the proper basis for earnings sharing is a combination of earnings above a return on equity of 10% and total shareholder return (dividend yield plus stock appreciation) in excess of 10%. *Id.* The return on equity should be calculated on the basis of Verizon Communications Inc.'s consolidated capital structure, an approach which has been supported by this Board, other jurisdictions, rating agencies and even Verizon's auditors. *Id.* In addition, the Board should continue to use Verizon's accounting book values rather than market value to determine the threshold for earnings sharing. *Id.*

In Section III.A.3. the Ratepayer Advocate discusses the reasons that Verizon-NJ should share with ratepayers the savings it realizes as a result of the Bell Atlantic-NYNEX and Bell Atlantic-GTE mergers. Verizon-NJ disputes this element of sharing, in essence, abandoning the commitment that Bell Atlantic made in seeking approval of the Bell Atlantic-NYNEX merger. *Infra* Section III.A.3.b. Moreover, the Board has already determined that sharing the savings attributable to these mergers is in the public interest. *Id.*

Under the Ratepayer Advocate's plan, Verizon-NJ would share merger savings and past excess earnings with ratepayers through a rate reduction of $148 million. *Infra* Section III.A.3.

The Ratepayer Advocate sets out in Section III.A.3. the basis for its calculation of merger savings that are to be shared. Under the Ratepayer Advocate's proposal, this rate reduction would be implemented by consolidating rate centers and expanding local calling areas. *Infra* Sections III.A.3, -B. The expansion of local calling areas would not only be a vehicle for passing the rate reduction on to consumers, it would have the benefit of conserving telephone numbers and area codes, which are becoming increasingly scarce in New Jersey. *Id.* In addition, ratepayers would receive a one-time refund of $43 million to account for merger savings already accrued. *Infra* Section III.A.3.

The Ratepayer Advocate proposes that the PAR retain existing provisions concerning exogenous events and quarterly reporting. *Infra* Section III.A.5. In addition, the Ratepayer Advocate urges the Board not to allow Verizon-NJ to add new services or restructure rates without adequate notice and a genuine opportunity to examine such proposals. *Infra* Section III.A.4.

Section III.D. of this brief addresses issues related to universal service. In establishing this proceeding, the Board ordered that the new plan contain a comprehensive examination of, and new proposals for, existing universal service mechanisms, including assistance for low-income consumers and aid to schools and libraries. *Application of Bell Atlantic-New Jersey, Inc., for Approval of a Modified Plan for an Alternative Form of Regulation and to Reclassify All Rate Regulated Services as Competitive Services*; *Application of Verizon New Jersey, Inc., for Approval of an Extension of its Plan for an Alternative Form of Regulation*, Order, Docket Nos. TO99120934, TO92030358, TO00120955 at 5 (December 22, 2000) ("December 22 Order").

While Verizon-NJ proposed some minimal expansion of its federal Lifeline and Access New Jersey programs, these proposals are insufficient. *Infra* Sections III.D.1.b, III.D.2.

Verizon-NJ's minimal expansion of its Lifeline program would do little to ensure the "affordability" of telephone service required by the New Jersey Telecommunications Act of 1992, N.J.S.A. 48:2-21.16-.21 ("1992 Act") Act and by the federal Telecommunications Act of 1996, Telecommunications Act of 1996, Pub. L. 104-104, Feb. 8, 1996, 110 Stat. 56, codified at 47 U.S.C. § 151 *et seq.* ("1996 Act"). *Infra* Sections III.D, III.D.2. Verizon-NJ does not demonstrate that service for low-income residents is affordable; instead, Verizon-NJ attempts to show only that service is more affordable for the average consumer. *Infra* Section III.D. To protect all low-income residents of New Jersey, the Ratepayer Advocate urges the Board to establish a state universal service fund that will include a component to ensure the affordability of telephone service to all low-income residents. *Infra* Sections III.D.1-III.D.1.a. In particular, eligibility for the state fund, as well as for the Lifeline program, should be expanded to include not just consumers currently participating in public assistance programs, but any household with an income at or below 175% of the federal poverty level. *Infra* Sections III.D.1.a, III.D.2.b. Further, the Ratepayer Advocate recommends that low-income residents be afforded the full Lifeline benefit of $10.50, rather than the partial $7.00 available today and recommended by Verizon-NJ. *Infra* Section III.D.2.a. Finally, the Ratepayer Advocate extols the Board to establish an automatic enrollment process for both the state low-income fund and the Lifeline program. *Infra* Sections III.D.1.a, III.D.2.c.

PAR-2 should also promote universal service by ensuring, through a state universal service fund, that advanced services are available to all schools and libraries statewide at

affordable, discounted rates, and from any provider that desires to provide the service, incumbent or competitor. *Infra* Section III.D.1.b. New Jersey's schools and libraries have a pressing need for assistance in bringing Internet connections to their communities. *Id*. Federal funding will not be enough to help New Jersey's schools and libraries meet this need, but New Jersey's telecommunications carriers, including Verizon-NJ, can fill this gap at reasonable cost. *Id*. In addition to the state fund, Verizon-NJ should extend its commitment to Access New Jersey, and expand the services covered by that program to include new technologies that are necessary to gain high-speed Internet access. *Id*. The Ratepayer Advocate's plan would accomplish these priorities. *Id*.

To ensure that all subscribers have full access to emerging telecommunications technologies, the Ratepayer Advocate proposes that the state fund include a high cost component to promote competition in areas where costs of local exchange service are at least twice the statewide average. *Infra* Section III.D.1.c. The high cost fund component will provide a needed incentive for carriers to serve those areas where slim margins might otherwise encourage such carriers to forego service, thus promoting competition in those areas. *Id*. The broad goal of local competition requires that the Board address the lack of competitive service in high cost areas; the Ratepayer Advocate's proposal solves this problem fairly and at a reasonable cost. *Id*. Funding for a statewide Universal Service Fund would be achieved by assessments on each carrier in New Jersey, based upon revenues generated from services originated or terminating within the state. *Id*.

Verizon-NJ's plan also includes a service quality standards program that will not be effective because it has no teeth, as it fails to include adequate, self-effectuating penalties for

deficient service. *Infra* Section III.E.1. The Ratepayer Advocate urges the Board to adopt specific statewide service quality standards with metrics that are directly linked to the earnings allowed under the plan of alternative regulation. *Infra* Section III.E.2.

In the CTP Order, the Board required that the next proposed PAR include specific proposals to address alleged subsidies in basic exchange services. CTP Order at 6. A realistic look at Verizon-NJ's costs and prices shows that its residential services, far from being subsidized, account for an oversized portion of Verizon-NJ's revenues, fully justifying earnings sharing and a rate adjustment. *Infra* Section III.C.

**Request For Reclassification Of Multi-Line Business Services**

Verizon-NJ also proposes reclassification of current multi-line business services from rate regulated to competitive status. PAR-2 Petition. We demonstrate below that Verizon-NJ fails to satisfy N.J.S.A. 48:2-21.19(b), the statutory standard for reclassification. *Infra* Section IV.B. In addition, the Ratepayer Advocate respectfully submits that the Board should now complete its statutory duty and compile a comprehensive list of criteria upon which to evaluate requests for reclassification. *Infra* Section IV.C. The Ratepayer Advocate recommends that, in addition to the three minimum criteria in the statute, the Board require at least evidence of the following: (1) the presence of effective competition, including the ability of competitors to offer services at competitive prices, terms and conditions; (2) UNE rates that reflect economic cost; (3) compliance with the section 271 checklist; (4) service-by-service examination of any proposed reclassification; (5) a showing of the likely impact of reclassification on other services; (6) the availability of prompt and effective dispute resolution for competitors; and (7) the existence of "air tight" service quality measures. *Id.* The addition of these criteria will not only satisfy the

statutory mandate, but will permit the Board to focus upon the real issue: whether effective competition protects New Jersey's ratepayers and curtails Verizon-NJ's ability to keep competition out of the market through an improper exercise of monopoly power.

**Structural Separation**

To establish conditions that will encourage competition to the fullest extent possible, the Ratepayer Advocate urges the Board to order full structural separation of Verizon-NJ's wholesale and retail operations, or, alternatively, order functional/structural separation achieved through a code of conduct with strict accounting requirements and effective penalties. *Infra* Section V. The record of this proceeding amply demonstrates that past regulatory efforts have not resulted in widespread, effective competition in New Jersey. *Id.* As a firm with a dominant position in local exchange service, Verizon-NJ has the incentive and ability to discourage competition by favoring its retail business units. *Infra* Section V.A. Structural separation is the only proven means to eliminate these incentives and abilities, and to eliminate with them many of the unearned competitive advantages that have enabled Verizon-NJ to dominate the markets in which it competes. *Id.* Precedent in New Jersey and elsewhere fully supports structural separation or a code of conduct that will replicate the results of structural separation. *Infra* Section V.B. In implementing structural separation, the Board should be careful to fashion accounting measures and penalties that will thoroughly eliminate Verizon-NJ's incentive to retard competition, and that fully mitigate the artificial advantages Verizon-NJ draws from its position as a local exchange monopolist. *Infra* Section V.C.

**Procedural History**

The Board approved the current PAR on May 6, 1993. 1993 Order. The Board required that Verizon-NJ seek extension or modification of the plan on or before January 1, 1999. *I/M/O Application of New Jersey Bell Telephone Company for Approval of its Plan for an Alternative Form of Regulation*, Order on Modified Plan for an Alternative form of Regulation and on Request for Confidential Treatment, Docket No. TO 92030358 (July 23, 1993). On December 30, 1998, Verizon-NJ requested an extension through January 28, 1999. *I/M/O the Application of Bell Atlantic-New Jersey, Inc. For Approval of an Extension of its Plan for an Alternative Form of Deregulation*, Decision and Order, Docket Nos. TO92030358 and TO98121462, May 24, 1999 ("PAR Extension Order"). The Board granted that request. *Id.*

On January 28, 1999, Verizon-NJ requested a one-year extension of its original PAR through December 31, 2000. *Id.* at 2. At a February 3, 1999 public hearing, the Board requested comments from interested parties on this request. On February 25, 1999, the Ratepayer Advocate petitioned the Board to compel Verizon-NJ to file a detailed extension proposal, with an opportunity for comment by all interested parties and evidentiary hearings. *I/M/O Application of Bell Atlantic-New Jersey Inc. for Approval of an Extension of its Plan for an Alternative Form of Regulation*, Motion for Reconsideration, New Jersey Division of the Ratepayer Advocate, Docket Nos. TO92030358, TO98121462 (February 25, 1999). On April 28, 1999 at its Agenda Hearing,

the Board denied that motion and extended the current plan through December 31, 2000.[2] PAR Extension Order.

On December 30, 1999, Verizon-NJ filed a new, one-page petition with the Board requesting approval of a modified PAR and approval of a new proposal, the CTP. Verizon-NJ requested in this single-page document the reclassification of all rate regulated services as competitive services. CTP at 1.

On January 27, 2000, the Board directed Verizon-NJ to file a detailed supplement to the CTP. That supplement was to address the savings and other effects from the recent mergers with NYNEX and GTE, as well as Verizon-NJ's plans for meeting all remaining commitments under the current plan. *I/M/O Application of Bell Atlantic-New Jersey, Inc., for Approval of a Modified Plan for an Alternative Form of Regulation and to Reclassify All Rate Regulated Services as Competitive Services*, Order, Docket No. TO99120934 (January 27, 2000).

Hearings on the CTP petition began on September 18, 2000. On October 30, 2000, after Verizon-NJ had presented its case, the Ratepayer Advocate orally moved to dismiss the petition. On November 9, 2000, the Ratepayer Advocate filed a brief in support of that motion. In a December 1, 2000, letter, Verizon-NJ sought to withdraw the petition and requested an extension

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[2] On July 7, 1999, the Ratepayer Advocate filed an appeal challenging the Board's authority under N.J.S.A. 48:2-21.18 to extend a Plan for an Alternative Form of Regulation without hearings or findings of fact. *Application of Bell Atlantic-New Jersey for Approval of an Extension of its Plan for an Alternative Form of Regulation*, Docket No. A-006018-98T2 (App. Div. N.J. 1999). In July 2001, the Court consolidated the appeal with another appeal of Board action without hearings. *Application of Bell Atlantic-New Jersey, Inc., for Approval of an Extension of its Plan for an Alternative Form of Regulation*; *Filing of Bell Atlantic-New Jersey, Inc., for the Reclassification of Existing Rate Regulated Services-Directory Assistance Services as Competitive*, Docket Nos. A-6018-98-T2, A-1059-99T3 (App. Div. NJ Jul.13, 2001). The Court ruled in favor of the Ratepayer Advocate regarding the appeal of the Board's decision on directory assistance. Notwithstanding its recognition that the extension had by then expired, the court stated that the same concepts regarding the need for hearings applied to any further extension of the current plan.

of the plan for an additional year, through December 31, 2001. In a December 5, 2000, letter, the Ratepayer Advocate opposed this request, arguing that, under N.J.S.A. 48:2-21.18, the Board could not extend the current plan without hearings and findings of fact. On December 22, 2000, after a brief comment period and without hearings, the Board ordered, *inter alia*, the extension of PAR-1 for an additional year (through December 31, 2001) and the filing of a new PAR proposal by Verizon-NJ. December 22 Order[3] The Board also determined that it would retain a consultant to conduct a comprehensive review of the financial integrity of Verizon-NJ. *Id* at 6..

Verizon-NJ filed a Petition seeking a new PAR and supporting testimony on February 15, 2001. PAR-2 Petition. That Petition also included a request that the Board deem competitive and deregulate all of Verizon-NJ's multi-line business services. *Id.* at 4-6. By letter motion dated February 26, 2001, the Ratepayer Advocate asked the Board to clarify its December 22 Order and determine whether Verizon-NJ's PAR-2 filing complied with that Order. On February 27, 2001, AT&T filed a Verified Answer and Cross-Petition requesting structural separation of the wholesale and retail operations of Verizon-NJ. In an April 6, 2001, letter, the Ratepayer Advocate recommended that the scope of the proceeding be expanded to include structural separation issues. On June 20, 2001, the Board (i) addressed the Ratepayer Advocate's request for clarification by requiring Verizon-NJ to file a proposal for the distribution of merger savings, and (ii) determined that the Board would consider structural separation in this proceeding, because the issue was relevant to the statutory standards for approval of a PAR. *Application of Verizon New Jersey Inc. for Approval (i) of a New Plan for an Alternative Form of Regulation*

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[3] On January 31, 2001, the Ratepayer Advocate filed a Notice of Appeal requesting the Appellate Division to review the legality of the Board's actions as set forth in the December 22, 2000 Order. The Court remanded the proceeding to the Board. *Id.*

*and (ii) to Reclassify Multi-Line Rate Regulated Business Services as Competitive Services, and Compliance Filing*, Order of Approval, Docket No. TO01020095 (June 20, 2001) ("June 20 Order"). On August 3, 2001, the Ratepayer Advocate filed testimony on the structural separation issue.

The Board held three public hearings in the proceeding.[4] The Board conducted evidentiary hearings on July 30, 2001; August 2, 8, 9, 30 and 31, 2001; September 7, 10 and 24, 2001; and October 1 and 5, 2001. On October 19, 2001, the Liberty Consulting Group submitted the results of the financial audit of Verizon-NJ that the Board ordered in its December 22 Order. *Final Report on the Review of the Financial Integrity of Verizon New Jersey*, The Liberty Consulting Group (Oct. 19, 2001) ("Liberty Audit"). The Board permitted discovery on issues raised by the Audit and held an evidentiary hearing on December 20, 2001. On December 19, 2001 the Board ordered a 90-day extension of the PAR.

## II. VERIZON-NJ IS NOT SUBJECT TO EFFECTIVE COMPETITION

In the view of the Ratepayer Advocate, the key to resolving each of the major issues before the Board is the state of telecommunications competition in New Jersey. Reliance on competition to replace regulation is the fundamental tenet of the 1992 Act. Before the Board can relax or eliminate its regulatory scrutiny of Verizon-NJ in any area, it must be sure that the Company truly faces effective competition in that area. Without regulation or effective competition, Verizon-NJ will have the incentive and ability to use its market power to raise prices, lower service quality, stifle innovation and frustrate entry by potential competitors. In the

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[4]The first two on August 13, 2001 in Newark and Trenton, and the second on October 1, 2001 in Millville.

absence of regulation, only effective competition would give Verizon-NJ the proper incentives to lower prices and increase service quality and innovation.

In PAR-1 the Board approved several mechanisms to promote competition in local exchange services. Thus, the Board approved safeguards intended to ensure: that (1) rate regulated services were not used to subsidize competitive services and (2) competitors had access to local exchange network services on the same terms and conditions as the incumbent. 1993 Order at 106, 124. Further, the Board included in PAR-1 Verizon-NJ's network modernization plan, Opportunity New Jersey ("ONJ"), which called for accelerated deployment of advanced switching and transmission technologies, as well as full broadband deployment by 2010. 1993 Order at 72-75.

Regrettably, these mechanisms did not result in the development of competition to effectively constrain Verizon-NJ's market power. Without this effective competition, there is no effective consumer choice. Verizon-NJ continues to dominate the local telecommunications market to the exclusion of competitive providers and to the detriment of consumers. As Ratepayer Advocate Blossom A. Peretz stated, five years after the enactment of the 1996 Act,

> New Jersey consumers are still waiting [for] competition and innovation. All efforts to date to facilitate the development of that competition in New Jersey's local telephone exchange market have prove[n] futile. Verizon's competitors have captured only a small and insignificant fraction of the local exchange market. Right now, here in New Jersey, Ratepayers have no choice.

T.33:9-19 (8/13/01).

The statistics bear out this concern. Nationwide, competitive carriers serve only 7.2% of lines in the local telecommunications market. Martha McKay, "Local Competition Still Elusive After the 'Revolution,'" THE RECORD (Feb. 8, 2001). (Attachment 1.) The situation is even worse in New Jersey. *See id.* (Verizon controls 6.5 million loops in New Jersey, compared to

only 219,929 loops controlled by other companies); see also Martha McKay, "Delay Looming in Local Phone Competition?" THE RECORD, Jan. 23, 2001 at L-8; Anthony Birritteri, "Clarity Needed in Telecommunications Competition Rollout," NJ BUSINESS, Oct. 2000, at 58. (Attachment 1).

Competition to provide advanced telecommunications services is also weak and diminishing. Instances of customers' inability to find digital subscriber line ("DSL") service they seek are well documented. See Roben Farzad, "SMARTMONEY.COM: My Kingdom For A DSL Line," DOW JONES NEWS SERVICE, Mar. 28, 2001 (Attachment 1). Although consumer demand is strong, advanced services such as DSL are simply not being deployed. Moreover, what competition there was is now declining, and this decline has been detrimental to consumers in New Jersey. See Martha McKay, "DSL Shutoff a Nightmare, Businesses Struggle Without Fast Internet Link," THE RECORD, Apr. 6, 2000, at B-1 (Attachment 1).

The recent rash of bankruptcies affecting many important would-be competitive carriers further dims the prospects for effective competition. *Five* of the "select" facilities-based carriers held up by Verizon-NJ to demonstrate effective competition have filed for bankruptcy since the initiation of this proceeding. Shooshan-Weber-Taylor Direct, Attachment 11, "Profiles of Selected Carriers Present in Verizon New Jersey's Territory"; s*ee* Andrew Backover, "As Dot-coms and Telecoms Crash, the Fallout Lands on Main Street," USA TODAY, June 25, 2001, at B.01; Dinah Wisenberg Brin, "Covad Bankruptcy Latest in Series for DSL Wholesalers," DOW JONES NEWS SERVICE, Aug. 7, 2001 (Attachment 1). The fallen include voice service providers WinStar and Teligent , as well as DSL providers NorthPoint, Rhythms and Covad. And the competitive carriers that remain are withdrawing from the markets they once served. Sprint, for

example, has discontinued its Integrated On-Demand ("ION") business service offering, which figures prominently in Verizon-NJ's claims of competition in multi-line business services. Shawn Young, "Sprint Plans to Cut 7% of Work Force After Posting 60% Drop in Net Income," WALL STREET JOURNAL, Oct. 18, 2001 (Attachment 1); *infra* Section IV.

This bleak competitive picture is at least in part traceable to Verizon-NJ's position as a monopolist. The difficulties that CLECs now face in their efforts to raise capital constrain their ability to enter markets with dominant incumbents. Roben Fazad, "Has the Telecom War Been Won?" Dow Jones News Service (May 15, 2001). The Board itself has found that limited access to unbundled network elements ("UNEs") and operations support systems ("OSS") is a major barrier to competition in New Jersey. *See New Jersey Board of Public Utilities, Status of Local Telephone Competition*, Report and Action Plan, Docket No. TX98010010 (July 1998) at 13. These barriers to competition parallel recent developments in the deregulated energy market in New Jersey where high wholesale costs are driving competitors from the market. See Kevin G. DeMarrais, "New Supplier Exiting N.J.'s Electric Market," THE RECORD, Nov. 8, 2000, at B-1; David P. Willis, "Brownout," ASBURY PARK PRESS, July 23, 2000, at B-1; Tom Johnson, "High Prices Heating Up Deregulation," THE STAR LEDGER, June 4, 2000, at 1. (Attachment 1).

Verizon-NJ's view of the market is markedly different. It asserts that many of the markets it occupies are competitive, basing this claim largely on a theoretical construct designed to ignore the real-world evidence of its continued dominance. In the end, Verizon-NJ's claim comes down to the assertion that certain markets are "open to competition" because the 1996 Act says they should be. This claim is wrong at every level. That a market is "open to competition" in Verizon-NJ's terms does not mean that it is subject to effective competition. Far from a guarantee of

effective competition, moreover, the 1996 Act embodies a recognition that without ongoing regulation the markets in which ILECs like Verizon-NJ compete will be subject to domination by those companies. Verizon-NJ's position, moreover, blithely assumes that the 1996 Act has worked to perfection, but the facts show that it has not.

In sum, Verizon-NJ's claim of "competition" in New Jersey is wholly without foundation, and supports neither the PAR that it has proposed nor its bold request to deregulate virtually all its business services. The absence of effective competition in New Jersey justifies a PAR that recognizes this continuing reality, rejection of Verizon-NJ's reclassification request, and a requirement that Verizon-NJ's wholesale and retail activities be structurally separated.

## III. VERIZON-NJ'S "NEW" PLAN FOR ALTERNATIVE RATE REGULATION SHOULD BE A REVISION TO THE EXISTING FRAMEWORK

When the Board established PAR-1, it sought to protect New Jersey ratepayers through various mechanisms designed to check the power of Verizon-NJ and to promote the just distribution of Verizon-NJ's earnings. These mechanisms included a moratorium on increases in tariffed rates for protected services through January 1, 1996 and index-based limits on increases thereafter. 1993 Order at 28. PAR-1 also required that Verizon-NJ share equally with ratepayers any intrastate rate of return earnings on Rate Regulated services in excess of 13.7 percent. 1993 Order at 44-45.

After Verizon-NJ withdrew its wholly deficient reclassification request, the CTP, the Board directed Verizon-NJ to refile its Plan for Alternative Regulation by February 15, 2001. CTP Order at 7. The Board noted that the new proposal should contain proof that it met the alternative regulation criteria established by the New Jersey Legislature in N.J.S.A. 48:2-21.18(a). Those statutory criteria require that a plan,

(1) will ensure the affordability of protected telephone services;

(2) will produce just and reasonable rates for telecommunications services;

(3) will not unduly or unreasonably prejudice or disadvantage a customer class or providers of competitive services;

(4) will reduce regulatory delay and costs;

(5) is in the public interest;

(6) will enhance economic development in the State while maintaining affordable rates;

(7) contains a comprehensive program of service quality standards, with procedures for board monitoring and review; and

(8) specifically identifies the benefits to be derived from the alternative form of regulation.

N.J.S.A. 48:2-21.18(a)(1)-(8).

Under the statute, therefore, the plan for alternative regulation of Verizon-NJ must accomplish several important policy goals. First, the PAR should protect New Jersey consumers, while ensuring that Verizon-NJ continues to deploy and develop rate regulated services as necessary to meet that fundamental goal. N.J.S.A. 48:2-21.18(a)(1)-(2). Second, the PAR should ensure affordable universal service for New Jersey residents. N.J.S.A. 48:2-21.18(a)(1). Third, the PAR should encourage the development of local exchange competition in New Jersey. N.J.S.A. 48:2-21.18(a)(3). To accomplish all this, a PAR must, among other things, regulate the conduct of Verizon-NJ *vis a vis* competitors and ratepayers when its conduct is not constrained by effective competition. Selwyn Direct at 63-64. The Ratepayer Advocate respectfully submits that Verizon-NJ's proposed new PAR fails to accomplish these goals and should be rejected by the

Board. The Verizon-NJ plan is nothing less than a complete abandonment of the provisions and principles that were central to PAR-1.

In place of Verizon-NJ's self-serving proposal, the Ratepayer Advocate recommends that the Board adopt its proposed PAR, which properly balances the interests of Verizon's shareholders with benefits for New Jersey telecommunications consumers, while providing a smooth transition to a competitive marketplace. Accordingly, the Ratepayer Advocate respectfully urges the Board to take several steps. First, the Board should require Verizon-NJ to maintain the $8.19 monthly rate for basic residential service for at least five years, as predictable, affordable rates should be a hallmark of a plan for alternative regulation. Second, the Board should require Verizon-NJ to share with ratepayers its excess earnings, and savings from the NYNEX and GTE mergers. The Board should implement the sharing of ongoing merger savings and past excess earnings through a rate reduction effectuated by consolidating rate centers and a concomitant expanding of local calling areas. This would benefit ratepayers by reducing fees for calls that had been billed at intra-state toll rates. In addition, the Ratepayer Advocate recommends that the Board return past merger savings to ratepayers through a one-time refund. Selwyn Direct at 75-76.

The Ratepayer Advocate also recommends that rates reflect earnings sharing and rate adjustment components that are calibrated to the phase-in of actual local exchange competition. Accordingly, the Ratepayer Advocate's proposed plan divides rates for regulated services into two "baskets," and places price caps on each basket to be determined according to Verizon-NJ's market share. As the marketplace becomes increasingly more competitive, Verizon-NJ is increasingly deregulated. All but essential "Basket 1" services are completely deregulated once

Verizon-NJ possesses a market share of less than 70 percent. All services are deregulated once Verizon-NJ's market share drops below 60 percent. If the Board adopts these measures, it will ensure that New Jersey ratepayers are protected, and at the same time give Verizon-NJ the incentive to decrease costs and develop new technologies for rate regulated services. *Infra* Section III.A.2.c.

A third goal of the PAR should be the continued availability of affordable basic services to all residents of New Jersey. To make this a reality, the Board should establish a state Universal Service Fund. It should also require Verizon to enhance its State Lifeline Program to ensure that all low income consumers obtain the full extent of Federal Lifeline assistance, and institute a program of automatic enrollment so that households that participate in public benefit programs would be automatically enrolled in the State Lifeline Program. In addition, the Ratepayer Advocate urges the Board to implement a High Cost Fund to encourage local exchange competition in high cost areas of the state. These mechanisms will ensure that the goal of universal service is advanced throughout the state.

Finally, the Board should ensure that Verizon-NJ is adequately regulated until local exchange competition fully develops under the mechanisms described above. To accomplish this, the Ratepayer Advocate submits that the Board should add self-effectuating penalties to the Service Quality program to better measure Verizon-NJ's performance in network provisioning, maintenance and reliability. These changes will help protect New Jersey ratepayers from Verizon-NJ's discretionary exercise of market power in the absence of effective competition.

### A. The Board Should Adopt the Ratepayer Advocate's Rate-Related Proposals and Reject Verizon-NJ's Proposals

New Jersey's rates for basic telephone service have long been among the very lowest in the nation. 1993 Order at 71. This important consumer benefit has been the result of the Board's leadership and its commitment to affordable telephone service for all ratepayers, one of the major policy objectives of the 1992 Act. Verizon-NJ's proposed PAR gives these vital policies short shrift, by abandoning the cap on rates that has protected New Jersey's consumers over the years, and eliminating the current plan's provisions for rate adjustments and earnings sharing.

The Ratepayer Advocate's plan, by contrast, would combine several mechanisms to ensure just and reasonable rates: (1) retention of the current cap on basic residential exchange rates for a five-year period, *infra* Section III.A.1.; (2) earnings sharing in amounts that diminish as competition increases, Selwyn Direct at 72-75; (3) rate adjustments that also diminish with increased competition, Selwyn Direct at 79-80; and (4) a one-time $43 million refund and a $148 million rate reduction, both of which would "reinitialize" rates so that at the outset of PAR-2 they are at a just and reasonable level, Selwyn Direct at 75-76. The permanent rate reduction would be implemented by consolidating rate centers and local calling areas. Selwyn Direct at 68. It would take into account actual results under PAR-1 and half of the expected savings from both the NYNEX and GTE mergers. The one-time refund would account for half the past savings attributable to Verizon-NJ from the NYNEX merger. Selwyn Direct at 76. We discuss earnings sharing in Section III.A.2., *infra*, and the sharing of merger savings that serves as part of the basis for the proposed permanent rate reduction and one-time refund in Section III.A.3., *infra*.

### 1. The Board Should Preserve the Rate Cap

Verizon-NJ's version of PAR would place affordable rates in jeopardy by eliminating the rate cap established in PAR-1. While Verizon-NJ does not now propose to raise rates, it attempts

to shed any obligation to sustain current rates. PAR-2 Petition at 1. Verizon-NJ's version of PAR-2 would allow the Company to seek a rate increase the day after the Board approved its plan. Selwyn Direct at 27. Moreover, the current rates cover the aggregate of all rate regulated services, and are thus subject to dilution every time one of those services is reclassified as de-regulated. Thus, for example, reclassification of all multi-line business services, as requested by Verizon-NJ in this proceeding, would permit significant rate *increases* in all other services that remain rate regulated as services are shifted out from under the cap. Selwyn Direct at 4. Verizon-NJ's attempt to achieve a major increase in these rates through its CTP proposal is evidence enough that Verizon-NJ is likely to make such a move again.

In determining whether the Board may relax current regulatory constraints on Verizon-NJ, the Board must carefully consider whether Verizon-NJ faces competition that will effectively constrain its conduct once regulatory controls are loosened. In the absence of full, effective competition, continued Board regulation is needed to ensure that Verizon-NJ does not retain excess earnings that result from its market power. Selwyn Direct at 16-17. Verizon-NJ's economic witness recognized this fundamental fact:

> Q. But you would agree there would be a need for a cap in that instance?
>
> A. Taylor: In the instance where there is not sufficient competition to constrain prices, yes, you need something. That's what regulation is for. You need something to prevent Verizon in it's own self-interest, from raising prices.

T.853:21-25 (8/30/01).

The Maine Public Utilities Commission has recognized the importance of competition in deciding whether to retain a rate cap. In its recent alternative regulation proceeding the Maine Commission extended its existing cap on basic local rates for an additional five years.

*Investigation into Verizon Maine's Alternative Form of Regulation*, Docket No. 99-851, Order (Part 2) at 4 (June 25, 2001) ("Maine Alt Reg Order).[5] The Maine Commission recognized that the presence of effective competition is the key to a determination whether rates should be capped. *Id.* at 4, 10-11. Verizon-NJ forsakes this important principle by proposing a plan of alternative regulation that utterly fails to take into account the proper regulatory responses to Verizon-NJ's market power.

Verizon-NJ's proposal to abandon a rate cap is a fundamental departure from the Board's approach in PAR-1. There, the Board ruled that,

> basic residential exchange telephone rates will continue to be stable until the year 2000, absent Board approved revenue neutral rate restructures or Board approved rate changes due to exogenous events.

1993 Order at 71. A firm rate cap, moreover, was not merely an invention of the Board. Rather, a rate cap follows naturally from the express Legislative policy of maintaining affordable rates. 1993 Order at 71, *citing* N.J.S.A. 48:2-21.16(a). In addition, capping residential rates will promote a rational price structure, since, contrary to Verizon-NJ's assertion, residential service revenues subsidize other Verizon-NJ services. Selwyn Direct at 46-62; *infra* Section III.C.

Therefore, the Ratepayer Advocate respectfully urges the Board to reaffirm its position in PAR-1 and require that rates for protected services not be raised during the proposed five-year term of PAR-2. The public policy rationale for a five year rate cap is supported by the AARP and others. According to Ms. Marilyn Askin, President, AARP New Jersey "Verizon-New Jersey's

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[5] In this proceeding the Maine Commission allowed an increase in basic rates, but took this step only to account for a Maine statute that effectively required Verizon to lower its access rates. Maine Alt Reg Order at 4. The Maine Commission treated this requirement as an event in the nature of an exogenous event under its plan of alternative regulation. *Id.* at 14.

$8.19 monthly charge for basic residential telephone service should be locked in for at least five years."  T: 81:7-10 (8/13/01). *See also* remarks of Assemblyman Gusciora. T: 35. 24 – 36.5 (4/18/01).

### 2. The Board Should Continue to Include an Earnings Sharing Component in PAR-2

#### a. Earnings Sharing Provides a Critical Proxy for the Nonexistent Competitive Pressure to Pass the Benefits of Productivity Efficiencies and Innovations to New Jersey Ratepayers

Verizon-NJ proposes that the Board abandon the rate adjustment and earnings sharing provisions that were fundamental to PAR-1.  In its decision approving PAR-1 the Board identified the value of these mechanisms in a plan of alternative regulation, finding that,

> earnings thresholds for index-based rate adjustments and for earnings sharing are reasonable and appropriate means of establishing and maintaining over the life of the plan a balance between providing reasonable and affordable prices for NJ Bell's customers, without the inefficiency, expense and delay of traditional rate base, rate of return regulation, and providing NJ Bell with the incentive to contain costs and to commit capital and accomplish accelerated deployment of an enhanced telecommunications network in as efficient a manner as possible.

1993 Order at 39; *see also*, Selwyn Direct at 17.  As the Board noted in the 1993 Order, moreover, Verizon-NJ's predecessor corporation believed at the time that,

> earnings thresholds operate as a reasonableness check and provide a balance among: (1) the desire to provide reasonable customer prices, (2) the need to provide incentives for business efficiency and marketing innovation; and (3) the need to eliminate inefficiencies and expense of traditional rate base, rate of return regulation

1993 Order at 33 (*quoting* New Jersey Bell Brief at 12).

The competitive situation that led Verizon-NJ to make this concession in PAR-1 persists in New Jersey today.  Earnings sharing and rate adjustments remain necessary to replicate

competitively determined results, because competition does not yet exist to effectively constrain Verizon-NJ's market power. Selwyn Direct at 15-16. Companies operating in truly competitive markets cannot expect to retain all the profits from efficiency gains or technological advances as competitors begin to match these achievements. *Id.* at 25. Rather, competition enables consumers to share the fruits of efficiency gains and technological advances as the lower prices that come with competition erode excess earnings and force firms like Verizon-NJ to pass on cost savings to consumers. *Id.* at 15. Without a regulatory mechanism to replicate that consumer benefit, alternative regulation will just be a formula for Verizon-NJ to reap above-competitive profits with consumers left out in the cold. *Id.* at 15-17, 63-64.

There can be no doubt that the market for residential exchange service is not competitive. *Supra* Section II. As of last year, Verizon-NJ put its share of that market at 96.5%. Selwyn Direct at 19. It must be remembered that Verizon-NJ did not, in any meaningful sense, *earn* that market position. Verizon-NJ's current dominance is largely the product of decades of regulation as a monopoly, funded by New Jersey ratepayers. Hempling Direct at 3-7. In these circumstances, Verizon-NJ can hardly claim an *entitlement* to excess earnings and cost savings that would accrue to consumers if the market were competitive. Accordingly, the Board should reject Verizon-NJ's effort to eliminate earnings sharing and rate adjustment provisions from PAR-2. Given its dominant market position, absent regulatory intervention, Verizon-NJ would have ample opportunity to deny New Jersey ratepayers any benefit derived from productivity and technological advances. As Dr. Selwyn explained, "were VNJ faced with real and effective competition in New Jersey, it would be forced to pass on cost savings to customers as these come to be reflected in lower market prices overall, or risk losing these customers altogether." Selwyn

Direct at 25-26. Without an earnings sharing mechanism, "VNJ would be permitted to retain indefinitely all of its efficiency and productivity gains and to flow all of the economic benefits therefrom solely to its shareholders." *Id.* at 26.

Thus, earnings sharing allows ratepayers to "directly benefit from the efficiency gains that are (presumably) stimulated by alternative regulation." *Id.* at 73. At the same time, it provides a "safety net" against "excessive pricing that may result from a misspecified price adjustment mechanism, since such sharing would result in at least a partial return of any monopolistic earnings" that Verizon-NJ might achieve. *Id.* at 73.

Recognizing these principles, the Board has specifically found that an earnings sharing mechanism is appropriate to ensure "the continuation of just and reasonable rates." 1993 Order at 30. The Board further found that earnings sharing provides technological and productivity incentives and is an appropriate mechanism for ensuring just and reasonable rates, consistent with state law.

> The Board concurs with NJ Bell and Staff that a sharing mechanism is appropriate and provides incentives for the deployment of an enhanced telecommunications network in as efficient and cost effective a manner possible even after the sharing threshold level has been achieved, while at the same time, insofar as earnings over the threshold may not all be retained by NJ Bell and must be shared with ratepayers, a sharing mechanism serves as an additional level of protection to ensure that rates paid by NJ Bell's customers are just and reasonable. Likewise, an earnings threshold level beyond which index-based rate increases cannot be imposed also serves as an additional safeguard to ensure that rates are just and reasonable.

*Id.* at 43.

The Board's analysis in the 1993 Order remains sound today. Earnings sharing continues to be appropriate and to provide incentives for advanced infrastructure investment. Moreover, it

remains a critical component in ensuring just and reasonable rates. Thus, for the same reasons that the Board adopted an earnings sharing mechanism in PAR-1, it should continue to include earnings sharing in PAR-2. Indeed, there is no legitimate reason for the Board to abandon earnings sharing in PAR-2.

#### b. The Board Should Continue to Use an Equity Analysis in Establishing the Earnings Sharing Threshold

In its attempt to eliminate earnings sharing, Verizon-NJ asserts that examination of the Company's return on equity is not appropriate because it will discourage productivity. West/Taylor Direct at 4. Contrary to Verizon-NJ's arguments, however, earnings sharing does not reduce its incentive to increase its efficiency and productivity. As Dr. Selwyn explained, to the contrary, there can be no dispute that Verizon-NJ "has a clear incentive to retain as much of its earnings as the Board will permit, and thus has a strong incentive to advance whatever arguments it can, flimsy as they may be, against a sharing requirement." Selwyn Direct at 74. Verizon-NJ has operated under earnings sharing since the Board enacted PAR-1 in 1993 and there is no evidence to suggest that this component in any way reduced its innovative and productivity incentives or in any way negatively impacted its operations. Thus, there is no justification to deviate from the Board's current practice of including earnings sharing and there are substantial public policy reasons for continuing such a mechanism.

Verizon-NJ also argues that an equity analysis is only appropriate in traditional rate of return regulation and that by continuing to include an earnings sharing component the Ratepayer Advocate is attempting to revert back to rate of return regulation. Vander Weide Rebuttal at 12. Contrary to Verizon-NJ's arcane argument, this analysis is a critical component of any earnings

sharing plan. Indeed, in its 1993 Order, the Board established a sharing threshold of 13.7% return on equity. 1993 Order at 44-45. The Board found this threshold was "consistent with the legislative intent that a plan will produce just and reasonable rates, be in the public interest, and at the same time balance the need to enhance economic development in the State." *Id.* at 44. Now that the Board is examining a new PAR, it should revise the return on equity threshold to reflect current economic conditions.

#### (1) The Board Should use Verizon Communications Inc.'s Consolidated Capital Structure to Establish the Appropriate Threshold for Earnings Sharing

The financial environment has changed substantially since 1993, when the Board established the earnings sharing threshold for PAR-1. Therefore, the Board should revise the threshold to reflect Verizon's current capital structure. The first step in revising this threshold is to select an appropriate proxy for Verizon-NJ's actual earnings. As Mr. Rothschild has demonstrated, the Board should use Verizon Communications, Inc.'s ("Verizon Inc.'s") consolidated capital structure, rather than that of Verizon-NJ, to form the basis for earned return on equity computations. Rothschild Direct at 7. The consolidated capital structure represents the structure through which common equity is actually raised from public investors. *Id.* at 7. While Verizon-NJ would prefer to base any equity analysis on Verizon-NJ's capital structure (Vander Weide Rebuttal at 43), Verizon-NJ's reported capital structure is an improper surrogate for the actual capital structure financing Verizon-NJ operations. Rothschild Direct at 7.

As an initial matter, Verizon-NJ's structure includes higher risk business operations, which puts upward pressure on the level of equity. It is well established that regulated operations pose a lower risk than non-regulated services. *Id.* at 7. Since lower risk investments are associated with

lower equity, if Verizon-NJ's regulated operations stood alone they would have less equity and more debt than the combined, regulated and non-regulated, Verizon-NJ operations. *Id.* at 7. A substantial portion (approximately 40%) of Verizon-NJ's operations, however, are higher risk business services. "Failing to recognize this in the capital structure selection process could have the effect of causing New Jersey intrastate regulated operations to subsidize the rest of Verizon New Jersey's business activities." *Id.* at 21. It is important to note that Verizon Inc.'s consolidated capital structure also includes these high risk/high equity services. For this reason, and as explained more fully below, the consolidated capital structure of Verizon Inc. is a conservative compromise and should be used by the Board in revising the earnings sharing threshold.

What is different, and problematic, about Verizon-NJ's capital structure, however, is that it is not established on a truly independent basis, but at the discretion of the parent company. *Id.* at 17; Liberty Audit at 18-22, 30-31, 36. Indeed, Verizon Inc. can easily manipulate Verizon-NJ's capital structure to produce the lowest cost of capital. Rothschild Direct at 21. Verizon Inc. controls the mix of debt and equity in Verizon-NJ and sets this mix on the basis of obtaining a favorable bond rating for cost of debt. *Id.* at 18; Liberty Audit at 22, 36. According to Exhibit RPA-19, Verizon Inc. directs Verizon-NJ to set its capital structure with the goal of being able to achieve a specific bond rating. Verizon Inc. has an economic incentive to keep Verizon-NJ's level of debt down because Verizon-NJ's debt is incorporated on Verizon Inc.'s books and the greater the debt the more equity is required to provide desirable capital structure ratios. Rothschild Direct at 18. Thus it is Verizon Inc. "and not Verizon New Jersey, that keeps control of the overview

perspective that includes the key cost tradeoffs between the mix of debt and equity in the capital structure of Verizon New Jersey." *Id.*

Moreover, the Board has recently sanctioned the use of a consolidated capital structure by adopting the Ratepayer Advocate's proposed cost of capital in the UNE proceeding. *In the Matter of the Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic New Jersey, Inc.,* Summary Order of Approval, Docket No. T000060356 at 5 (December 17, 2001)("December 17 UNE Order"). In that proceeding, the Ratepayer Advocate proposed an 8.8% weighted cost of capital based on Verizon, Inc.'s consolidated capital structure. Ratepayer Advocate Initial Brief at 39. The Board specifically found that the Ratepayer Advocate's "analysis is the most reasonable and forward-looking analysis in the record." December 17 UNE Order at 5. This analysis was based on a consolidated capital structure. Thus, the Board has already accepted, and ordered rates based on, the use of a consolidated capital structure. For the same reasons the Board adopted a consolidated capital structure analysis in the UNE proceeding, it should adopt such a structure in this proceeding.

**(2) Other Jurisdictions, Rating Agencies, and Verizon's Auditors Have Found that Use of a Consolidated Capital Structure is Appropriate**

The Board's use of a consolidated capital structure is in step with findings on this issue by other commissions, Standard & Poors, Moody's and Verizon Inc.'s auditors, PricewaterhouseCoopers, LLP ("Pricewaterhouse"). Specifically, the FCC and the District of Columbia Public Service Commission ("D.C. Commission") have concluded that it is appropriate to use consolidated, rather than the subsidiaries', capital structure. Rothschild Direct at 9. As the FCC explained, the "capital structure of the BOCs should not be used in determining the overall

interstate access cost of capital because *the capital structure of those entities is subject to manipulation by the holding companies*." *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, 5 FCC Rcd. 7507 (December 7, 1990) ¶8 (emphasis added). Therefore, the FCC used the "composite cost of debt and capital structure of the RHC's in calculating the overall unitary rate of return." *Id*.

Similarly, in a proceeding involving then Bell Atlantic subsidiary, Chesapeake and Potomac Telephone Company ("C&P"), the District of Columbia Commission found that the subsidiary was "not free to reject" the debt ratio range established by Bell Atlantic. Case No. 926, Order No. 10353 at 23-24 (December 21, 1993) ("D.C. Order"). In addition, the D.C. Commission found that the subsidiary was "unable to provide evidence that it does not continue to manipulate dividend payouts to Bell Atlantic in order for Bell Atlantic to maximize its consolidated overall rate of return." *Id.* at 23-24. Finally, that Commission noted that Bell Atlantic's level of equity was lower than that of C&P, and found that circumstance:

> inconsistent with the general rule that the amount of equity in a company's capital structure is directly related to that company's business risk…. C&P's reliance on a comparison of its capital structure with that of other regulated LECs is misplaced. As OPC argued, the companies cited by C&P are subsidiaries that have the same incentives and opportunities to manipulate their capital structures to maximize the rates they can charge.

*Id.* at 23-24

Moreover, as Liberty Consulting noted in their recent financial audit, both Standard & Poors and Moody's agree that use of a consolidated capital structure is appropriate. Indeed, these agencies will not assign telecommunications subsidiaries a higher credit rating than the parent, because the subsidiary is only as strong as the parent holding company. Liberty Audit at

24-26. According to Liberty, Moody's has found that "there are two main driving forces behind this ratings convergence (between parent and telephone subsidiary)." *Id.* at 25. First, "local telephone companies are increasingly being managed as a single business" rather than separate stand-alone entities. *Id.* at 25. Second, the number of companies operating under a common umbrella is growing as RBOCs "seek through diversification and consolidation to develop [] service offerings, geographic footprint, critical mass, and efficiencies." *Id.* at 25. Thus, there is a growing trend among rating agencies to recognize the consolidated capital structure of telecommunications companies.

Finally, Verizon's auditors, Pricewaterhouse, also espouse using the holding companies' capital structure. Rothschild Direct at 27-28. In a proceeding in which Pricewaterhouse represented the Long Island Power Authority in a proposed takeover of some of the electric utility assets of the Long Island Lighting Company, Pricewaterhouse advised the Board of Trustees of the New York State Long Island Power Authority that:

> whenever you have a situation where you have a holding company, it is important to have provision for hypothetical cap structure *because a holding company can capitalize its operating companies any way it wants*, a hundred percent equity or anything else in between, a hundred percent debt or anything else in between.[6]

Thus, the FCC, the DC Commission, independent rating agencies, and Verizon Inc.'s auditors agree that the parent company's capital structure should be used precisely because the subsidiary's capital structure is easily manipulated and thus does not give an accurate representation of the capital structure financing the operation in question. For these same

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[6] A transcript of the entire trustee meeting of June 11, 1997 is available on the website of the Long Island Power Authority at http://www.lipa.state.ny.us . The referenced quote appears on page 95 of the transcript. Emphasis has been added.

reasons, the Board should use Verizon, Inc.'s capital structure to establish the earnings sharing threshold.

**(3) Verizon's Consolidated Capital Structure Provides a Conservatively High Cost of Equity Estimate**

Verizon Inc.'s consolidated capital structure provides a conservatively high amount of common equity financing for regulated services in New Jersey because it includes the higher risk unregulated operations, which produce a higher percentage of equity. Rothschild Direct at 7-8. As Mr. Rothschild explained, the higher risk of the non-regulated services causes Verizon Inc.'s "consolidated capital structure to contain more equity than if all of the operations owned by Verizon were of comparable risk to Verizon's regulated operations in New Jersey." *Id.* at 8. Because the consolidated capital structure includes higher risk services, it puts upward pressure on the level of common equity. "Therefore, whatever percentage of common equity in the capital structure that is appropriate for Verizon Communications as a whole will overstate the level of common equity in the capital structure that is proper for the New Jersey intrastate regulated operations." *Id.* at 22.

**(4) The Board Should Use Verizon Inc.'s Accounting Book Value Rather than Verizon Inc.'s Market Value to Determine an Appropriate Earnings Sharing Threshold**

In modifying the earnings sharing mechanism, the Board should use Verizon Inc.'s accounting book value rather than the Company's market value for purposes of establishing a threshold. *Id.* at 22. Accounting book valuations examine the actual investment made in the Company by including both the original invested capital and retained earnings. *Id.* at 23. A

market valuation, on the other hand, is based on the stock price multiplied by the number of shares outstanding. *Id.* at 23.

It is standard practice for this Board to apply Verizon, Inc.'s actual accounting book valuations in determining an appropriate capital structure. *Id.* at 22. As a witness in numerous proceedings before this Board, it has been Mr. Rothschild's experience that in all cases "in which a capital structure was determined, the BPU has determined the capital structure based upon the accounting book value of the company's capital, not its market value." *Id.* at 22-23. Moreover, Verizon's board of directors uses book value to determine the company's capital structure. *Id.* at 23 (citing RPA-72b). Likewise, rating agencies such as Moody's and Standard and Poors use actual book capital structure, not the market value capital structure. *Id.* at 24. Thus, there is strong precedent and evidence in support of using Verizon Inc.'s book values.

**(5) The Board Should Adopt a 10% Cost of Equity Earnings Sharing Threshold**

As explained above, the Board used an equity analysis in establishing the earnings sharing threshold for PAR-1 and it should continue to use this criterion in revising this threshold. However, given the substantial change in the financial world, in particular a significant decrease in Verizon's cost of equity since the Board adopted PAR-1, the Board should update the earnings sharing threshold to reflect Verizon Inc.'s current cost of equity. Thus, contrary to Verizon-NJ's attempt to confuse the issues by arguing that the Ratepayer is seeking to "regulate rates via a determination of costs and expenses," (Vander Weide Rebuttal at 9), the Ratepayer is simply seeking to bring PAR-1 up to date with more current financial data.

Verizon Inc.'s current cost of equity is 10%. Rothschild Direct at 30.[7] This finding is supported both by recent precedent in New Jersey, as well as the record evidence presented in this proceeding. As explained above, in the recent UNE proceeding, the Board adopted the Ratepayer Advocate's proposed cost of capital, derived from "a 10% cost of equity based upon data from Value Line Reports adjusted for risk." December 17 UNE Order at 5. Finding that this analysis was the "most reasonable and forward-looking analysis in the record," the Board must have necessarily concluded that Verizon's cost of equity is 10%. *Id.* at 5.

Furthermore, there is additional recent precedent for the use of a 10% return on equity. In recent gas and water rate cases, the parties stipulated to a 10% return on equity. *In the Matter of the Petition of Public Service Electric and Gas Company for Approval of an Increase in Gas Rates and for Increase in Gas Rates and for Charges in the Tariff for Gas Service, B.P.U.N.J. No. 12, Gas Pursuant to R.S. 48 2-21 and 48.2-21*, Initial Decision Settlement, OAL DKT. No. PUC 5052-01 at 5 (December 26, 2001); *In the Matter of the Petition of Elizabethtown Water Company for Approval of an Increase in Rates for Service*, Stipulation, BPU Docket No. WR 0104 0205 ¶ 5 (January 3, 2002). Thus, there is strong precedent that the Board should use a 10% cost of equity in this proceeding.

Moreover, as the record evidence in this proceeding demonstrates, a 10% cost of equity is sustained by both a discounted cash flow ("DCF") and risk premium/CAPM analyses. Rothschild Direct at 29-35, JAR 2. Verizon Inc.'s current cost of equity using the DCF method, which looks at the stock dividend plus future expected growth, provides a cost of equity of 10.02%. *Id.*, JAR

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[7] While the Ratepayer strongly urges the Board to use the consolidated capital structure of Verizon, Inc., if the Board decides to use Verizon-NJ's reported capital structure, it should establish cost of equity at 9.5%. Rothschild Direct at 30.

2. The conservatively high nature of a 10% cost of equity is further evidenced by the 9.50% cost of equity for similar telephone companies. *Id.* at 33-34, JAR 2. Likewise, the risk premium/CAPM method, which examines both the interest rate and inflation rates, provides an 8.94% cost of equity. *Id.*, JAR 2. Averaged together, the DCF and risk premium/CAPM method produce a cost of equity of 9.5, which the Ratepayer rounds up to a conservative 10% cost of equity. *Id.*, JAR 2.

Verizon Inc.'s prospectus and independent analysis also support a 10% cost of equity. Verizon Inc.'s Joint Proxy Statement for 1999 Annual Meetings of Shareholders and Prospectus contains a valuation analysis conducted by Salomon Smith Barney. A 10% cost of equity is the mid-point of the 9% to 11% range that Salomon Smith Barney used in its valuation analysis. *Id.* at 11, RPA-34 at I-41.

Clearly, a 10% cost of equity is conservative when compared to the 14.56% average returns realized by Verizon investors since 1993. *Id.* at 11, JAR 3. The recent financial audit of Verizon-NJ conducted by Liberty Consulting confirms the Ratepayer Advocate's findings, lending further support to the conservative nature of a 10% cost of equity. In terms of Verizon-NJ, a 10% return is highly conservative given the "robust return on average equity of over 30 percent in each year since Bell Atlantic's major asset write-down in 1994." Liberty Audit at 31. Indeed, even Verizon-NJ's intrastate rate regulated services produced substantial returns ranging from a low of 8.8% to a high of 15.62% over this same time period. *Id.* at 11. These returns provide "a healthy 'economic profit' and creation of value for the company." *Id.* at 31. In short, the "company's economic profit during the past several years is obviously substantial." *Id.* at 31.

Thus, the record evidence demonstrates that a 10% return on equity is not only reasonable, but conservative. Rothschild Direct at 30.

Finally, the Board should order Verizon-NJ to permanently reduce rates to reflect the current return on equity in excess of the cost of equity. As demonstrated by Mr. Rothschild in Revised Schedule JAR 1 at 3, and confirmed by Liberty Consulting's Financial Audit, Verizon-NJ has realized substantial returns on equity. Using the conservative 10% cost of equity, Verizon-NJ has enjoyed over $56 million in excess revenue. Revised JAR 1 at 3. Since Verizon-NJ does not face the competitive pressure that would otherwise force the company to share these excess revenues with ratepayers, the Board should order Verizon-NJ to reduce its rates by $56 million. When combined with the $91 million rate reduction for ongoing merger savings, discussed in the following section, Verizon-NJ should institute a permanent rate reduction of $148 million. Revised JAR 1 at 3.

#### c. The Board Should Adopt The Ratepayer Advocate's Approach To Earnings Sharing and Rate Adjustment

The Ratepayer Advocate's proposed approach to earnings sharing and rate adjustment would allow Verizon-NJ flexibility and freedom from regulation to the extent it faces competition. Conversely, it would ensure that consumers would not lose the protection afforded by regulation unless competition is truly effective in constraining Verizon-NJ's pricing. The Ratepayer Advocate's plan provides a graduated approach to regulatory and pricing flexibility that serves these complementary objectives.

The earnings sharing, rate adjustment and rate cap mechanisms should be applied differently to two baskets of services. Basket 1 would consist of the basic exchange dial tone line

with touch tone. Basket 2 would include all other rate regulated retail services. Selwyn Direct at 69. Basket 1 rates would be capped at existing rates unless and until Verizon-NJ's market share was less than 60%. Basket 2 rates would be deregulated when Verizon-NJ's market share fell below 70%. Therefore, once Verizon-NJ's market share was below 60% Verizon-NJ's services would be deregulated – no price caps, rate adjustments or earnings sharing would apply– although the Board could take competitively neutral actions to ensure that residential basic exchange service remained affordable. Selwyn Direct at 69-71. *See, In the Matter of Motion of AT&T Corp. To be Reclassified as a Non-Dominant Carrier*, Order, FCC 95-427, 11 FCC Rcd 3271 (1995), at para. 68. There the FCC agreed that when AT&T had shed 40% equity of its share in the long distance market it would be deemed a non-dominant carrier, concluding that a 40% market share loss is objectively indicative of a competitive market.

Earnings sharing would be determined under a formula that would pass on to ratepayers 25% of earnings in excess of a 10% return on consolidated equity plus 25% of total return (dividend yield plus stock appreciation) in excess of 10%. Selwyn Direct at 72-73. The amount derived from this formula would be adjusted to account for the presence of competition. If Verizon-NJ 's market share exceeded 90%, the full sharing amount would be passed on to ratepayers. If that share fell to between 80% and 90%, only half the sharing amount would be passed on, and for shares between 70% and 80% a quarter of that amount would be passed on to ratepayers. There would be no earnings sharing if Verizon-NJ's market share fell to below 70%. Selwyn Direct at 69-70.

The effect of these provisions is summarized in the table below:

| **Verizon-NJ Market Share** | | **Basket 1 RBES plus dial tone** | **Basket 2 All other regulated retail** |
|---|---|---|---|
| more than 90% | RATE CAP | Yes ($8.19) | At original level |
| | RATE ADJUSTMENT | No | Applied 100% |
| | EARNINGS SHARING | Applied 100% | |
| 80% to 90% | RATE CAP | Yes ($8.19) | At original level |
| | RATE ADJUSTMENT | No | Applied 50% |
| | EARNINGS SHARING | Applied 50% | |
| 70% to 80% | RATE CAP | Yes ($8.19) | At then-current level |
| | RATE ADJUSTMENT | No | No |
| | EARNINGS SHARING | Applied 25% | |
| 60% to 70% | RATE CAP | Yes ($8.19) | No |
| | RATE ADJUSTMENT | No | No |

| | EARNINGS SHARING | No | |
|---|---|---|---|

| | | | |
|---|---|---|---|
| less than 60% | RATE CAP | No | No |
| | RATE ADJUSTMENT | No | No |
| | EARNINGS SHARING | No | |

The Ratepayer Advocate's plan for rates under PAR-2, therefore, takes into account current and prospective competitive conditions. It deregulates those rates as the market reaches a point at which it can be deemed truly competitive. In addition, the Ratepayer Advocate's plan enables ratepayers to share in excess earnings and cost savings, as they would in a market with effective competition, and it does so in a manner that is sensitive to actual competitive conditions in the market.

**3. The Board Should Order Verizon-NJ to Share Half of its Merger Savings with New Jersey Ratepayers**

**a. New Jersey Ratepayers are Entitled to Share in the Billions of Dollars of Merger Savings**

There can be no dispute that Verizon-NJ has realized, and will continue to realize, billions of dollars in net cost savings and revenue enhancements as a result of its mergers with NYNEX and GTE. While the following section addresses the quantification of these benefits, it is important to note that the Company acknowledges that it has already realized billions of dollars in expense savings from the NYNEX and GTE mergers. Hall Updated Direct, Exhibit C-1R, Exhibit D-4. Furthermore, the Company will continue to enjoy millions of dollars in expense and

capital savings, as well as revenue enhancements, on a going-forward basis. Rothschild Direct, JAR 11 at 1.[8]

Notwithstanding these monumental savings, Verizon-NJ adamantly refuses to share even a penny with New Jersey ratepayers. Hall Direct at 26-27. Verizon-NJ argues that ratepayers have no "ownership rights in the business" and that "in a competitive environment" it is "unfair" to "bind the hands of one competitor to the advantage of others." *Id.* at 27. Verizon-NJ's argument is again based on the faulty premise that it is operating in a competitive environment. As explained above, if the New Jersey telecommunications market were truly competitive, then ratepayers would automatically and necessarily share in Verizon-NJ's productivity and efficiency advances, including those achieved through the NYNEX and GTE mergers, because they would be under competitive pressure to pass these benefits to consumers. In that situation, a regulatory requirement for merger sharing might not be necessary. However, Verizon-NJ continues to dominate the local market in New Jersey and does not face the competitive pressure to share its merger savings with ratepayers. The Board has ordered Verizon-NJ to share these billions of dollars in merger benefits and it should now do so, or else New Jersey ratepayers will be shut out of any real benefit from either of these mergers. As Verizon-NJ agreed, in this industry, if price competition does not exist, then regulation is appropriate. T:710.2-8 (8/8/01). Therefore, the Board should provide a proxy for competitive pressure in the form of regulation that requires Verizon-NJ to pass a portion of these benefits to consumers.

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[8] On November 5, 2001, the Ratepayer Advocate filed a Motion to Correct the Record with an affidavit by Mr. Rothschild correcting a mathematical error detected in his earlier testimony on merger savings. Attached to the affidavit was a revised Schedule JAR 11 demonstrating the Ratepayer's calculation of merger savings. All citations to JAR 11 are to this revised spreadsheet, which is attached to this Brief as Attachment 2.

New Jersey ratepayers have sustained Verizon-NJ's operations for decades and as such are "entitled to benefit from the merger savings." Rothschild Direct at 12. Indeed, it is only fair that ratepayers share in these exorbitant savings. Specifically, the Board should balance the interests of investors and ratepayers and require Verizon New Jersey to pass on to New Jersey ratepayers (1) a one-time refund to reflect their proportionate share of the historical merger savings from the BellAtlantic/NYNEX merger, and (2) a permanent rate reduction to reflect their proportionate share of the ongoing savings from both the Bell Atlantic/NYNEX merger and the Bell Atlantic/GTE merger. *Id.* at 13.

#### b. There is Strong Precedent for Sharing of Merger Savings

Sharing of merger savings is consistent with the Board's investigation and approvals of these mergers. In its order approving the NYNEX merger, the Board expressed its policy that any merger savings be shared with ratepayers. Specifically, the Board stated that it "must be satisfied that the merger is consistent with law, that it will not cause economic or financial harm to ratepayers and that *New Jersey ratepayers will have access to a share of any benefits relating to this merger*." NYNEX Merger Order at 2 (emphasis added). Moreover, in its order approving the merger, the Board noted that it was concerned "whether New Jersey ratepayers will receive a share of the projected benefits of the merger." *Id.* at 5. Indeed, Verizon specifically committed to sharing merger savings with New Jersey ratepayers when it sought regulatory approval for this merger. Then BellAtlantic CEO Len J. Lauer committed that New Jersey ratepayers would be recipients of "an appropriate sharing of benefits" resulting from the Bell Atlantic/NYNEX merger. *I/M/O Board's Review of the Amended and Restated Agreement and Plan of Merger*,

Supplemental Statement, Docket No. TM96070504, (February 5, 1997) at 7-8. The Board should hold Verizon to its commitment to share merger savings.

Similarly, the Board found that it would be in the public interest to share savings resulting from the GTE merger. In its order approving the merger, the Board left to a future proceeding *only* the determination as to "*what extent* such savings should be shared between customers and shareholders." GTE Merger Order at 8. Thus, this Board has already proclaimed and sanctioned the principle that Verizon should share its merger savings with New Jersey ratepayers.

Furthermore, sharing of these savings with ratepayers is consistent with Board merger orders in other industries. For example, in its order approving the merger of Rockland Electric and Edison Company of New York, the Board ordered the allocation of 75% of Rockland Electric's share of net merger savings to ratepayers. *Consideration of the Joint Petition of Orange & Rockland Utilities, Inc. for Approval of the Agreement and Plan of Merger and Transfer of Control*, Order, Docket No. EM98070433 at 15 (April 4, 1999).

Similarly, the Board approved the Atlantic City Sewerage sale of property to the New Jersey Department of Transportation, in which half of the benefits of the sale were shared with New Jersey ratepayers. *In the Matter of the Petition of the Atlantic City Sewerage Company for Authorization to Make, Execute and Implement An Agreement of Sale, and to Implement a Plan of Distribution of the Net Proceeds Therefrom*, Order of Implementation, Docket No. WM98090790 at 4 (January 14, 1999) ("Atlantic Merger Order"). The Board noted that the Atlantic sale was similar to another sale involving the Hackensack Water Company, in which "the Board directed that one-half of the gain from the sale of excess reality should be shared equally by all ratepayers." *Id.* at 4.

More recently, the Board approved stipulated sharing of merger savings in the merger between FirstEnergy and GPU Energy. *In the Matter of the Joint Petition of FirstEnergy Corp. and Jersey Central Power & Light Company, D/B/A GPU Energy, For Approval of a Change in Ownership and Acquisition of Control of a New Jersey Public Utility and Other Relief*, Order of Approval, BPU Docket No. EM 00110870 at 20 (October 9, 2001). See also, *In the Matter of the Petition of Atlantic City Electric Company and Conectiv Inc. for Approval of a Change in Ownership and Control*, Order, Docket No. EM97020103, (January 7, 1998) at 7-8;

Thus, the Board has established a clear precedent of ordering utilities to share merger savings with New Jersey ratepayers. The Ratepayer Advocate urges the Board to sustain its consistent precedent and require Verizon-NJ to share with New Jersey ratepayers half of the benefits that Verizon-NJ has realized, and will continue to realize, from its mergers with NYNEX and GTE.

**c. A Fifty Percent Share of Verizon's Historical and Going-Forward Merger Savings Equates to a One Time Refund of $43 Million and a Permanent Rate Reduction of $92 Million Per Year**

The Board should order Verizon-NJ to implement a one-time refund of $43 million to reflect a sharing of Verizon-NJ's historical merger savings and a permanent rate reduction of an estimated $92 million per year, to reflect on-going savings. Revised JAR 11. The $43 million one-time refund is half of the estimated $85 million net savings allocated to Verizon-NJ's intrastate regulated operations for 1997-2000. Rothschild Direct, JAR 11 at 1. The $92 million permanent rate reduction represents half of the estimated $184 million expected merger savings

on a going forward basis. Revised JAR 11 at 1. The derivation of these figures is explained in detail in Revised JAR 11, Attachment 2, and summarized below.

| NYNEX Merger | 1997-2000 Cumulative Benefits | Estimated Ongoing Benefits |
|---|---|---|
| Total Merger Savings to Verizon, Inc. from NYNEX Merger | $3.166 billion | $1.425 billion |
| Total Merger Savings to Verizon, Inc. from GTE Merger | N/A | $2.698 billion |
| Total Merger Savings Attributable to Intrastate Rate Regulated Services | $85 million | $184 million |
| 50% of Merger Savings | $43 million | $ 92 million |

As shown on the table and explained in detail in Revised JAR 11, the Ratepayer Advocate derived these figures by aggregating Verizon's estimated total historical expense savings for the NYNEX merger and calculating ongoing expense savings for both mergers after 2000. Mr. Rothschild then incorporated the revenue enhancements and capital cost savings that Verizon enjoys as a result of these mergers. It is appropriate to include these benefits, "because revenue and capital cost benefits produce benefits that are just as real as operating benefits." Rothschild Direct at 40. Verizon clearly contemplated these benefits in evaluating the mergers. According to its Joint Proxy Statement for 1999 Annual Meetings of Shareholders and Prospectus:

> Based on anticipated revenue and expense synergies, we expect that the merger will improve earnings per share, excluding merger-related charges, in the first year following completion. We estimate that the merger will also generate significant capital synergies, producing higher capital efficiency and higher cash flow and margin growth.

Exhibit RPA-19 at I-25.

Accordingly, Mr. Rothschild added revenue enhancements, offset by expense increases associated with these enhancements, and capital savings, which are also adjusted. While Verizon-

NJ claims that it has not separately quantified revenue enhancements from overall revenue growth, it does not dispute that such enhancements exist. Exh. RPA 38, RPA-VZ 64. The fact that Verizon-NJ refuses to quantify these savings does not justify denying New Jersey ratepayers the benefit of these savings.

Verizon-NJ's scant tracking and reporting was independently confirmed by Liberty Consulting's recent financial audit. Liberty was clearly frustrated in its attempt to quantify certain merger savings. Indeed, Liberty expected "far more in the way of formal and detailed documentation of merger actions and their successes." Liberty Audit at 51. What little information Verizon-NJ submitted to the Board on this issue was only done because the Board required the Company to track and report on its savings. Moreover, those reports do not include effects on capital and revenues. While Verizon-NJ has refused to track or report to the Board on capital synergies, when it sought approval for the mergers it identified expected capital synergies in detail to the New Jersey level. *Id.* at 56. It is only now when the issue of merger savings sharing arises that Verizon-NJ claims to be unable to calculate these benefits. The Board should not allow Verizon to hide its savings from ratepayers through skimpy reporting. As Liberty Consulting noted in its findings, the opportunity for Verizon-NJ's customers to benefit from capital synergies comes "from avoiding additions in capital plant and the related effects on net-income accounting." *Id.* at 56.

In other words, the Board should not allow Verizon-NJ to hide these capital savings and revenue enhancements from ratepayers by refusing to quantify them. These additional savings are an important and real component of Verizon's merger savings. As the 1997 Annual Report for then Bell Atlantic explained:

> By the year 2000, the Company is targeting recurring expense savings of approximately $1.1 billion and approximately $300 million a year in capital savings by consolidating and integrating networks and operating systems, eliminating approximately 3,100 management positions, centralizing procurement, reducing the need for contract services, consolidating real estate, combining information systems and eliminating duplicative operations. The Company expects to add approximately $400 million a year in revenues from its current product portfolio by using best marketing and advertising practices.

Bell Atlantic 1997 Annual Report at 1 (available at http://investor.verizon.com/SEC/html/0000950109/0000950109-97-002420.html). The revenue enhancements and capital savings provided in Bell Atlantic's 1997 Annual Report confirm the Ratepayer Advocate's independent calculations of these savings.

After incorporating the savings and enhancements, Mr. Rothschild then prorated the total benefits of both mergers to capture the savings attributable to Verizon-NJ's intrastate rate regulated services. Revised JAR 11 at 1. These savings were in turn offset by regulated merger costs to provide total merger savings of $85 million for the years 1997-2000 and an estimated $184 million per year in ongoing savings. *Id.* These savings were divided in half to produce the one-time $43 million refund, representing New Jersey ratepayers' share of historical cost savings[9] and the $92 million per year in permanent rate reductions, representing New Jersey ratepayers' share of ongoing merger savings. *Id.*[10]

#### 4. The Board Should Reject Verizon-NJ's Attempt to Gain Unwarranted Pricing Discretion Using its Proposed Procedures for Introducing New Services and Rate Restructuring

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[9] The Ratepayer Advocate did not propose a specific method for refunding the $43 million to ratepayers. The Board, at its discretion, may decide to allocate these funds to establish a state universal service fund. In the alternative, the Board may decide to use these funds to support Access New Jersey.

[10] As explained above, when combined with the $56 million to account for the current return on equity in excess of the cost of equity, the Board should order a permanent rate reduction of $148 million. The Board should implement this rate reduction through an expansion of local calling areas as described in the following section.

Beyond its naked attempt to free itself of meaningful, necessary incentive regulation, Verizon-NJ proposes that it be given unwarranted discretion to impose prices, terms and conditions on telephone subscribers, without sufficient scrutiny by the Board. None of this discretion is justified by the competitive position of Verizon-NJ. Under Verizon-NJ's plan, it would gain the ability to rearrange its service offerings and pricing to the detriment of consumers by the introduction of what it calls "new service" and revenue neutral rate restructuring.

Under Verizon-NJ's plan, the company would gain unwarranted ability to escape needed regulation by introducing "new" services. By repackaging competitive and non-competitive services as a "new service," Verizon-NJ could force customers using protected services into migrating into unregulated "new" services. Selwyn Direct at 34-37. These changes in the way services are regulated could become effective on five days' notice, without public input or Board review. These procedures are clearly insufficient, particularly given the uses Verizon-NJ could make of this "new service" provision. Selwyn Direct at 32-33. Accordingly, the Ratepayer Advocate urges the Board to adopt a 30-day notice period for the institution of new services, after which the Board could approve the new service offering if there had been no objections. Selwyn Direct at 33-34.

The Verizon-NJ plan would also give it the ability to seek "revenue neutral rate restructuring" under procedures that would hamper Board review. This aspect of the plan would limit the Board to a 90-day period for review of Verizon-NJ's proposed rate restructuring. In PAR-1 the Board rejected a limit on its ability to analyze such an important matter (1993 Order at

67) and the Ratepayer Advocate submits that it should not change its position here. Selwyn Direct at 37, 66.

### 5. The Board Should Not Eliminate the Plan's Exogenous Event Provisions

Verizon-NJ's proposed elimination of the current plan's exogenous event provisions would complicate and burden the regulatory system, leaving Verizon-NJ with unwarranted advantages over competitors and customers in seeking changes to the plan. Eliminating the current plan's exogenous event provision would essentially require that changes in the PAR occur only after a protracted, burdensome rate case. This would deprive the Board of needed flexibility in responding to unanticipated changes, and discourage parties from seeking such a response by imposing a burden that would almost surely be disproportionate to their interest in the matter. Selwyn Direct at 27-28. In sum, this proposal by Verizon-NJ is an unworkable, unacceptable requirement that surely does not measure up to the statute's call to "reduce regulatory delay and costs." 1992 Act § 48:2-21.18(4) (2001). The Ratepayer Advocate respectfully recommends that the Board continue its current procedures related to exogenous events.

### 6. The Board Should Continue to Require Quarterly Financial Monitoring Reports by Verizon-NJ

Verizon-NJ's proposed elimination of quarterly financial monitoring reports would deprive the Board of an important vehicle for monitoring the success of the PAR it orders in this proceeding. Selwyn Direct at 29-30. This proposal is founded on the basic flaw in Verizon-NJ's proposal: it erroneously assumes that the markets in which Verizon-NJ participates are competitive enough that Board scrutiny may be reduced to next to nothing. The Board should retain this requirement of quarterly reporting.

### 7. Verizon-NJ's Proposals for Rate Treatment under the New PAR Do Not Satisfy the Statutory Criteria; The Board Should Adopt the Ratepayer Advocate's Proposals in PAR-2

For the reasons discussed above, the rate-related aspects of Verizon-NJ's proposal do not satisfy the statutory criteria for a plan of alternative regulation, and should be rejected in favor of the Ratepayer Advocate's proposal. The absence of a firm cap on rates means that the Verizon-NJ plan will not "ensure the affordability of protected services." 1992 Act § 48:2-21.18(1) (2001); *see* Selwyn Direct at 39-40. Because Verizon-NJ would eliminate earnings sharing and rate adjustment as well as fail to account for excess earnings and merger savings, its plan would not "produce just and reasonable rates." 1992 Act § 48:2-21.18(2) (2001); *see* Selwyn Direct at 40. The Ratepayer Advocate's proposal for a rate cap, rate adjustment and earnings sharing would protect subscribers and meet these statutory standards by calibrating rate treatment to the level of competition in the market.

The rate-related provisions of the Verizon-NJ plan would likely "prejudice or disadvantage" customers and competing providers. 1992 Act § 48:2-21.18(3) (2001). In particular, the Company's ability under its plan to reshape its offerings as "new services" and restructure its rates on limited Board review are a distinct threat to subscribers. Selwyn Direct at 41. In addition, the plan provides no workable mechanism to protect competitors from Verizon-NJ's use of cross-subsidization and discriminatory tactics. Selwyn Direct at 41-42. The Ratepayer Advocate's plan would properly address these important procedural matters.

As discussed above, Verizon-NJ's proposals for new service and revenue neutral rate restructuring would not "reduce regulatory delay and costs," 1992 Act § 48:2-21.18(3) (2001). Instead, they would enable Verizon-NJ to evade proper regulatory scrutiny. The elimination of

the exogenous events provisions would affirmatively increase regulatory delay and costs. Selwyn Direct at 42. The Board should not abandon these important regulatory mechanisms.

Furthermore, Verizon-NJ's proposals will do nothing to enhance economic development in New Jersey. 1992 Act § 48:2-21.18(6) (2001); Selwyn Direct at 43-44. Rather, they will stifle competition and leave Verizon-NJ in the position of a monopolist content with its lucrative *status quo*. For all these reasons, the Verizon-NJ plan for regulating its rates would not be in the public interest. 1992 Act § 48:2-21.18(5) (2001); Selwyn Direct at 43. The Ratepayer Advocate urges the Board to adopt its proposed PAR-2, which is sensitive to the needs and rights of ratepayers and to the competitive concerns that undergird telecommunications regulation today.

### B. The Board Should Adopt the Ratepayer Advocate's Proposal to Expand Local Calling Areas

Local calling areas in New Jersey are the smallest of any state in the nation. West-Taylor Direct at 9-10. In its December 22 Order, the Board expressed concern about this and expressly contemplated that geographic expansion of local calling areas should be part of any plan of alternative regulation.

> Further, [Verizon-NJ] shall include [Verizon-NJ's] analysis and recommendations as to whether the Board should consider the following options as part of the new Plan:
>
> (1) geographic expansion of local calling areas and the collapsing of toll bands: with regard to the analysis of the geographic expansion of local calling areas, [Verizon-NJ] shall provide several options, each of which shall include the cost of the expansion, the number of access lines included in each new calling area and the expected rate impact to consumers.

December 22 Order at 6; *see* Williams Direct at 3. As a result, both Verizon-NJ and the Ratepayer Advocate submitted testimony containing an analysis of, and recommendation on,

whether the Board should order that local calling areas be expanded. West-Taylor Direct at 27-30, Exh. 7; Williams Direct at 2-50; Selwyn Direct at 76-78. Only the Ratepayer Advocate presented a plan that would both maintain existing local rates and expand local calling areas. Williams Direct at 13-24; Selwyn Direct at 76-78.

Verizon-NJ looked at four implausible local calling area expansion scenarios. Scenario 1 would have eliminated toll band 1 (0-10 miles) and established a single statewide rate for basic residence service and a single rate for basic business service. West-Taylor Direct at 28 and Exh. 7. Scenario 2 would also have eliminated toll band 1, but would have established two rate groups for residential service and two for business service. West-Taylor Direct at 28 and Exh. 7. Scenario 3 is the same as Scenario 1, except that it would also eliminate toll band 2 (11-15 miles). West-Taylor Direct at 28 and Exh. 7. Scenario 4 is the same as Scenario 2, except that it would also eliminate toll band 2. West-Taylor Direct at 28 and Exh. 7. Verizon-NJ only evaluated these four options on a "break-even basis" – *i.e.*, assuming that any intraLATA toll revenue losses must be offset by equivalent gains in local exchange revenues. West-Taylor Direct at 28 and Exh. 7; Williams Direct at 9; Selwyn Direct at 78. Consequently, Verizon-NJ rejected the four scenarios because each would have required Verizon-NJ to propose raising residential local rates *in order for the scenarios to remain revenue neutral for Verizon-NJ*. West-Taylor Direct at 28 and Exh. 7; *see* Williams Direct at 9; Selwyn Direct at 78.

In contrast to Verizon-NJ, the Ratepayer Advocate recommends that the Board expand local calling areas, reducing the number of rate centers in New Jersey from 180 to 21, each based on county borders (unless a county crosses a LATA boundary). Williams Direct at 4-5, 42; Selwyn Direct at 77-78. The new local calling area for each rate center should be all exchanges in

the county that contains the rate center, plus all exchanges in all contiguous counties (again excluding any exchanges that cross LATA boundaries). Williams Direct at 4-5, 42-43; Selwyn Direct at 77-78. In this way: (1) the $148 million in Verizon-NJ merger savings and excess earnings, *supra* Sections III.A.2, -.3, can be returned to consumers through the reduction of intraLATA toll charges, and (2) the existing rate of $8.19 for basic residential service can be maintained. Williams Direct at 13-24.

### 1. Verizon-NJ's Local Calling Area Analysis Improperly Adds a Revenue-Neutrality Requirement

When unpacked, the assumptions that Verizon-NJ built into its local calling area analysis *guaranteed* that Verizon-NJ would not – indeed, could not – recommend any local calling area expansion plan to the Board. Specifically, Verizon-NJ built into its analysis the following assumptions: (1) the rate for local exchange calls should not change from the current $8.19 rate, *see* West-Taylor Direct at 8-9; and (2) any plan must be revenue neutral to Verizon-NJ. West-Taylor Direct, Exh. 7 at 3. The first assumption may be appropriate. The second assumption – revenue-neutrality – is not. By revenue-neutrality, Verizon-NJ means that any intraLATA toll revenues must be offset by revenue gains from other aspects of the plan. West-Taylor, Exh. 7 at 3 ("Assumptions . . . There is recovery of lost toll and access revenue . . .to implement expanded local calling areas.").

An expansion of local calling areas will necessarily reduce Verizon-NJ's intraLATA toll revenues. The only way local calling areas could be expanded in a revenue neutral scenario would be for basic residential local rates to rise to cover the loss in toll revenues. Yet, Verizon-NJ properly also builds into its analysis the assumption that local residential rates will remain at their

current level. *See* West-Taylor Direct at 8-9. By premising its local calling area expansion analysis on these two assumptions, Verizon-NJ therefore obviated the need to conduct any analysis whatsoever. It would be mathematically impossible for any local calling area expansion plan to satisfy these two criteria simultaneously. *See* Williams Direct at 9-13. Accordingly, Verizon-NJ's analysis of ways to expand local calling areas was designed to fail.

Moreover, Verizon-NJ's use of a revenue-neutrality assumption was completely arbitrary. Nowhere in the December 22 Order did the Board require that only plans that are revenue neutral for Verizon-NJ be examined. Rather, Verizon-NJ unilaterally added this requirement. Thus, instead of studying the expansion of local calling areas to benefit ratepayers, Verizon-NJ misconstrued the Board's mandate by adding a requirement that effectively rendered any analysis useless. The Board should not permit this disregard for the spirit of its December 22 Order to stand.

**2. The Board Should Adopt the Ratepayer Advocate's Local Calling Area Expansion Plan To Effectuate the $148 Million Rate Adjustment**

In contrast to Verizon-NJ's disingenuous examination of expanding local calling areas, the Ratepayer Advocate's plan is a genuine plan intended to be implemented and designed with the primary purpose of benefiting New Jersey citizens, rather than only Verizon shareholders. T.37:3-12 (8/13/01); *see* Selwyn Direct at 76-78. This consumer first approach is a key reason the Ratepayer Advocate's plan was endorsed by AARP New Jersey in the remarks its President, Ms. Marilyn Askin, presented to the Board: "And we feel that consumers in New Jersey rather than the shareholders of [Verizon-NJ] should reap the benefits of this." T:89-18-21 (8/13/01). Specifically, the Ratepayer Advocate proposes returning to consumers Verizon-NJ's $148 million

in excess earnings and merger savings, *supra* Sections III.A.2., -.3, by expanding calling areas and consolidating today's small 180 rate centers to 21 county-based areas (adjusted for LATA boundaries).[11] Williams Direct at 4-5, 38-44; Selwyn Direct at 76-78. By reducing the number rate centers to 21, the Ratepayer Advocate's plan will result in the return of considerable intraLATA toll costs to ratepayers. Williams Direct at 16-24.

The Ratepayer Advocate's proposal for expanding local calling areas would resolve many of the problems associated with New Jersey's unusually small local calling areas, and do so as part of an overall plan of alternative regulation for Verizon-NJ. Williams Direct at 13-16, 22-24. While the $8.19 rate for residential stand-alone dial-tone service is the lowest of any state in the country, *see* West-Taylor Direct at 9-10, this low rate is significantly offset by the high intraLATA toll charges paid by New Jersey residential subscribers. Williams Direct at 16-24. In fact, intraLATA toll charges in New Jersey are the sixth highest in the United States, Williams Direct at 21-22, Att. 2, and the intraLATA toll market in New Jersey is the fourth largest in the United States. *Application by Verizon New Jersey Inc., Bell Atlantic Communications, Inc. (d/b/a Verizon Long Distance), NYNEX Long Distance Company (d/b/a Verizon Enterprise Solutions), Verizon Global Networks Inc., and Verizon Select Services Inc., for Authorization to Provide In-Region, InterLATA Services in New Jersey*, CC Docket No. 01-347, Application by Verizon New Jersey for Authorization to Provide In-Region, InterLATA Services in New Jersey at 85 (filed Dec. 20, 2001) ("Verizon-NJ FCC 271 Application").

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[11] While Verizon-NJ witnesses claimed in their pre-filed testimony that New Jersey has either 204 rate centers, Shooshan-Weber-Taylor Direct at 31 n.35, or 208 rate centers, West-Taylor Rebuttal, Att. A at 1, when being cross-examined Verizon-NJ admitted that there are 180 rate centers in New Jersey. T.214:7-21 (07/30/01).

This disparity between exceedingly small local calling areas and very large intraLATA toll markets impedes the development of residential local exchange competition. Indeed, Verizon-NJ specifically admits this in its recently filed FCC 271 application.

> The unusually large size of the intraLATA toll market in New Jersey has meant that competition for residential service in New Jersey has focused disproportionately on local toll service rather than on basic local exchange service.

Verizon-NJ FCC 271 Application at 86 (citing Taylor Decl. ¶ 28). By implication, consolidating rate centers and expanding local calling areas will facilitate the development of competition in the residential local exchange market in New Jersey.

The small size of local calling areas in New Jersey not only leads to higher residential telephone bills and little residential local exchange competition, but it causes much confusion by residential customers in the process. *See* Williams Direct at 24-25. Ms. Blossom Peretz, Director of the Ratepayer Advocate, illustrated this confusion in her August 13, 2001 remarks to the Board:

> New Jersey suffers from some of the smallest calling areas. We know that calling Grandma two towns over in the same county is a regional toll call in many areas. . . .
> From what we understand today, and what we hear when ratepayers make a call, they don't know what two towns away is a local call and three towns away is a toll call.

T.42:19-21; 54:3-7 (8/13/01). Perhaps even more revealing were the statements of Dorothy Argyros from Neighbors United in Neptune, New Jersey. Ms. Argyros came before the Board largely because she was having trouble resolving some issues on her phone bill. Part of her confusion centered around how calls to friends and relatives, who live only a short drive away from her, could be so expensive.

> What costs such a lot of money is my brother in Red Bank, which is 20 minutes away. I can almost talk to him cheaper by getting in my car and going there. I have a friend in Freehold, that is half an hour away, that is the county seat. And I have a friend in Middletown. And they – that – those [sic] are the calls that drive my bill up so high.

T.149:18-150:2 (8/13/01).

Eliminating this confusion is one of the main reasons that the Ratepayer Advocate is proposing a rate reduction by expanding local calling areas through consolidation of the existing 180 rate centers to twenty-one (21) county-wide rate centers. Williams Direct at 4-5, 38-44; T.43:22-44:4, 53:5-56:3 (8/13/01). Counties are an appropriate basis for the proposed new local calling areas expressly because they are well understood by New Jersey consumers. T.53:18-54:2 (8/13/01). Indeed, in her remarks to the Board, Ms. Argyros stated that the replacement of today's small local calling areas with county-based local calling areas should alleviate some of her confusion.

> What I am really hoping you'll do and I'm supporting the Ratepayer Advocate's application that you take away Verizon [NJ]'s ability to charge me big bucks for a call to Red Bank . . .
>
> I think the county system is very good because I really don't know when I sit down to make a call whether it is a toll call or not. . . . And I won't know until the bill comes in.

T.150:12-151:3 (8/13/01). By establishing twenty-one (21) local calling areas based on county boundaries, Ms. Argyros and all of the nearly 8.5 million residential New Jersey consumers will know when they are making a local call and when they are making an intraLATA toll call. *See* http://factfinder.census.gov/bf/_lang=en_vt_name=DEC_2000_SF1_U_DP1_geo_id=04000US34.html.

For these reasons, the Board should effectuate the $148 million rate adjustment by adopting the Ratepayer Advocate's local calling area expansion plan.

### 3. Expanding Local Calling Areas Would Alleviate Telephone Number Exhaust Problems and Promote Number Conservation

The Board should also endorse the rate center consolidation and local calling area expansion plan of the Ratepayer Advocate because it will alleviate telephone number exhaust and the need for new area codes by promoting number conservation.[12] These are long standing goals of the FCC, the Board and, indeed, the entire telecommunications industry. *E.g.*, *Numbering Resource Optimization*, CC Docket Nos. 99-200, 96-98, 95-116, FCC 01-362, Third Report and Order and Second Order on Reconsideration in CC Docket No. 96-98 and CC Docket No. 99-200 (rel. Dec. 28, 2001) ("FCC Numbering Optimization Order"); *Implementation of Numbering Resource Optimization Through Thousands-block Number Pooling in Each of New Jersey's 201, 973, and 732 Area Codes*, Decision and Order, Docket No. TX01050313 (May 9, 2001) ("NJ Number Pooling Order"). In fact, just last month, the FCC reiterated these goals.

> [W]e continue efforts to maximize the efficiency with which numbering resources in the North American Numbering Plan (NANP) are utilized. . . . [W]e aim . . . to ensure that the limited numbering resources of the NANP continue to be used efficiently so that the NANP does not exhaust prematurely, and to ensure that all carriers have the numbering resources they need to compete in the telecommunications marketplace.

FCC Number Optimization Order ¶ 1. More importantly, the FCC previously found:

> rate center consolidation to be a vitally important long-term measure to optimize the utilization of numbering resources [and] . . . that rate center consolidation should be implemented to the greatest extent possible.

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[12] As of mid-1999, at least 7 states had implemented or indicated that they planned to implement rate center consolidation. *Number Resource Optimization*, CC Docket No. 99-200, RM No. 9258, NSD File Nos. L-99-17, L-99-36, FCC 99-122, Notice of Proposed Rulemaking ¶ 115 n. 185 ("FCC Number Optimization NPRM").

FCC Number Optimization NPRM ¶ 116.

Reducing the number of rate centers in New Jersey to 21 would drastically reduce the quantity of telephone numbers that a local exchange carrier would need to provide service throughout New Jersey. Williams Direct at 4, 42; Selwyn Direct at 77-78. The Board's recent order on number pooling began the process of conserving telephone numbers by requiring that numbers in the 201, 973 and 732 area codes be assigned in 1,000 number blocks by February 15, 2002.[13] NJ Number Pooling Order at 1-3. If adopted, the Ratepayer Advocate's proposal would continue the Board's efforts to conserve numbers.

Previously, carriers generally obtained telephone numbers in traditional 10,000 number blocks. In order for a CLEC to provide service throughout the entire state of New Jersey – *i.e.*, in each of the 180 rate centers – that CLEC would initially need to obtain 1.8 million numbers. Williams Direct at 42; Selwyn Direct at 77. With the number of rate centers reduced to 21, that same CLEC would only need to obtain 210,000 numbers state-wide. Williams Direct at 42-43. Even at this lower number, the CLEC is likely to have obtained many more numbers than its initial business plans require. Nevertheless, adoption of the Ratepayer Advocate's plan would conserve 1.59 million telephone numbers.

Under 1,000 block number pooling, the Ratepayer Advocate's plan would still conserve a considerable amount of numbers. Even in the most optimistic scenario – *i.e.*, where a carrier has already obtained a 10,000 number block in each rate center and where a single 1,000 number

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[13] At the time the Ratepayer Advocate filed its initial testimony, the NJ Number Pooling Order had not yet been adopted by the Board. Therefore, the testimony sponsored by the Ratepayer Advocate assumed that numbers would be assigned in the pre-number pooling amount of 10,000 number blocks per exchange. As detailed in this Section, however, the implementation of number pooling in no way detracts from the number conserving aspects of the Ratepayer Advocate's proposal.

block is available for assignment to a CLEC entering the New Jersey market state-wide – (extrapolating from the above figures) the Ratepayer Advocate's plan would reduce the amount of telephone numbers that the CLEC would need from 180,000 to 21,000. This would conserve 159,000 numbers per CLEC. If, on the other extreme, a CLEC were to enter the New Jersey market on a state-wide basis and 1,000 number blocks were not available in any rate center, then the Ratepayer Advocate's plan could again lead to the conservation of 1.59 million lines. *See* Williams Direct at 42-43. This number conservation would be complemented by number pooling, which would enable the conservation of additional numbers by permitting the CLEC to assign unused blocks of 1,000 numbers in each rate center. While the actual amount of numbers conserved would fall somewhere between 159,000 and 1.59 million, regardless of where in this range the amount lies, the number conservation accomplished would be considerable. *See* Selwyn Direct at 78 n. 72.

Additionally, because many carriers, including CLECs and Verizon-NJ, obtained 10,000 number blocks prior to the NJ Number Pooling Order, many carriers may be able to return excess telephone numbers under the Ratepayer Advocate's proposal. Williams Direct at 42-43. By reducing the amount of numbers a carrier requires to provide state-wide service from 1.8 million to 21,000, the combination of the Ratepayer Advocate's proposal and the NJ Number Pooling Order would likely enable carriers to return tens or hundreds or thousands, or perhaps millions, of telephone numbers to the number administrator.

By conserving telephone numbers, the Ratepayer Advocate's plan would also reduce, or perhaps eliminate, the need to deploy additional area codes in New Jersey. *See* FCC Number Optimization NPRM ¶ 113 ("Rate center consolidation . . . prolong[s] the life of an area code.").

By the end of this year, New Jersey will have grown to nine area codes from six in 1999 and three in 1995. Williams Direct at 28; *see* Selwyn Direct at 77. The reservation of number blocks, whether in 10,000 or 1,000 increments, in many or all of the 180 rate centers has been a prime contributor to number exhaust in existing area codes, thus creating the need for additional area codes in New Jersey. Williams Direct at 27-30; Selwyn Direct at 77-78. The proliferation of new area codes imposes considerable societal costs, including consumer frustration and confusion. Williams Direct at 32-37. By contributing to the conservation of telephone numbers, the Ratepayer Advocate's proposal would help alleviate, or at least delay, the need for additional area codes, thereby avoiding these costs. Williams Direct at 3-4, 27-37.

Reducing the need for additional area codes will also provide carriers – including Verizon-NJ – with substantial future savings because they will not need to upgrade their facilities and systems to implement additional area codes. Williams Direct at 4, 35-37. More specifically, in its discovery responses, Verizon-NJ claimed, without quantifiable support, that implementation of a new area code in New Jersey costs up to $ 15 million. RPA Exh. 57, VNJ-RPA 396. By alleviating the need for additional area codes, the Ratepayer Advocate's plan would lead to millions of dollars of future savings for Verizon-NJ, savings that must be weighed against any costs Verizon-NJ alleges that it would incur to implement the plan.

#### 4. Verizon-NJ's Attacks on the Ratepayer Advocate's Plan Inappropriately Attempt to Place Verizon-NJ's Profits Above the Needs of Ratepayers and Should Therefore Be Given No Credence by the Board

The Board should reject Verizon-NJ's criticisms of the Ratepayer Advocate's local calling area expansion plan because they represent nothing more than baseless attempts to inject

confusion in order to spare Verizon-NJ from having to provide a rate adjustment that will return excess revenues to ratepayers.

Verizon-NJ, in opposing the Ratepayer Advocate's plan, inappropriately seeks to maximize its high intraLATA toll revenues. This is an improper reason to maintain small local calling areas. High intraLATA toll charges suppress the use of telephone service and harm economic and social activity associated with the use of such service. Williams Direct at 24-25. For example, small local calling areas and high intraLATA toll charges discourage telecommuting. Williams Direct at 24. Thus, expanding local calling areas would benefit the New Jersey economy.

Moreover, the Ratepayer Advocate's plan is designed to be fair to Verizon-NJ. Only half of the merger savings are proposed to be returned to New Jersey, *supra* Section III.A.3., and the Ratepayer Advocate only proposes reducing the number of local calling areas to 21. Williams Direct at 4-5, 42-43. In developing its plan, the Ratepayer Advocate recognized that Verizon-NJ's intraLATA toll revenues – the 6th highest in the United States – comprise much of its revenues from residential customers. Williams Direct at 21-22, 45-48. The existence of twenty-one (21) local calling areas will still continue to generate significant intraLATA toll revenues for Verizon-NJ.

Just as Verizon-NJ's toll revenues are not sacrosanct, there is nothing sacred, contrary to Verizon-NJ's claim, about the current definition of local calling areas in New Jersey. Local calling areas do not need to be defined by population as Verizon-NJ would have the Board believe. *See* Williams Direct at 14-15; West-Taylor Rebuttal, Att. A at 5-6. Throughout the country there is no direct correlation between population and local calling areas. Williams Direct

at 22-24. For example, the largest local calling area in the United States contains the entire Atlanta metropolitan area, including the suburbs and areas beyond the suburbs. *See* Williams Direct at 23. Further, Verizon-NJ's claim that population increases within existing local calling areas warrant keeping local calling areas small is similarly without merit. Williams Direct at 14-16; *see* West-Taylor Rebuttal, Att. A at 2-4. Populations have increased within toll areas just as they have within local calling areas. Williams Direct at 14-16.

Finally, Verizon-NJ's additional argument that the Ratepayer Advocate's rate center consolidation plan would be difficult to implement or prohibitively expensive is without merit. West-Taylor Rebuttal, Att. A. Verizon-NJ does not substantiate its claim that the Ratepayer Advocate's plan would necessitate many changes to Verizon-NJ's network and those of interconnecting CLECs. West-Taylor Rebuttal, Att. A at 5-6. No other party supported Verizon-NJ's assertion. Indeed, Verizon-NJ undermines its own allegation regarding the network configuration difficulties that would ensue under the Ratepayer Advocate's plan, West-Taylor Rebuttal, Att. A at 5, by admitting that **[BEGIN VERIZON PROPRIETARY]**

**[END VERIZON PROPRIETARY]** of its intraLATA toll customers already utilize optional calling plans. West-Taylor Rebuttal at 49. By offering optional calling plans Verizon-NJ is already providing residential consumers with what are essentially larger local calling areas, but for a fee.[14] With the majority of Verizon-NJ's residential toll customers already using

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[14] For example, one of Verizon-NJ's optional calling plans, Selective Calling Service, provides customers with the ability (for a fee) to effectively make local calls without incurring toll charges to people in areas that would normally result in intraLATA toll calls. Bell Atlantic – New Jersey, Inc., Tariff B.P.U.-N.J.-No. 2 § 6.3.2(A) (1997).

optional calling plans, much of the supposed reconfiguration work necessary to implement larger local calling areas must have already occurred as a prerequisite to offering optional calling plans.

As in so many other instances, when pressed during cross-examination (and discovery), Verizon-NJ's witnesses admitted that Verizon-NJ had not performed any study on the impact of implementing the Ratepayer Advocate's rate center consolidation plan.

> Q. Has Verizon done any study of the cost of implementing Rate Center consolidation before it decided to take such action [opposing such consolidation]?
>
> A. West: I know of no such study.
>
> Q. Dr. Taylor?
>
> A. Taylor: No, I don't know.

T.1777:17-22 (8/31/01); *see* RPA Exh. 57, VNJ-RPA 396 ("Verizon-NJ has not conducted any analysis of the costs to implement the Ratepayer Advocate's plan."). Thus, Verizon-NJ has provided no basis for rejecting the Ratepayer Advocate's proposal.

In the end, Verizon-NJ's criticisms are nothing more than a plea that the Board reject the Ratepayer Advocate's proposal because it is not revenue neutral, and instead return excess earnings and merger savings to New Jersey consumers.

> If the Board were to adopt a scenario to expand local calling areas, which it should not do, rate structure changes are a necessary prerequisite . . . [T]he recovery of revenue losses and implementation costs provides the Board with a unique opportunity to address the public policy issues associated with pricing of residential basic exchange service in New Jersey with minimal impact on customers as increases in basic exchange service would be offset by decreases in intraLATA toll billing.

West-Taylor Rebuttal, Att. A at 4. More egregiously, Verizon-NJ objects to the rate center consolidation plan specifically because it passes the benefits of Verizon-NJ's excessive earnings

and merger savings to consumers instead of shareholders – that is, Verizon-NJ opposes the plan because "expanding local calling areas would enhance the value of basic exchange service." West-Taylor Rebuttal, Att. A at 4. In this one respect, Verizon-NJ has it just right – enhanced value for ratepayers is precisely why the Ratepayer Advocate's proposal should be adopted by the Board.

### C. The Board Should Endorse the Ratepayer Advocate's Residential Service Cost Subsidy Analysis and Reject Verizon-NJ's Analysis

The Board should recognize that Verizon-NJ's subsidy analysis for basic residential service is fundamentally flawed, and should instead rely upon the Ratepayer Advocate's analysis. In its December 22 Order, the Board specifically required submission of a residential service subsidy analysis.

> [Verizon-NJ] is *HEREBY DIRECTED* to submit [the] following:
>
> > (1) a specific proposal for the Board to consider to address alleged subsidies in basic exchange services, in the event that the Board determines that it is appropriate to maintain (or lower) the existing $8.19 residential basic service rate, or establish some other rate below the long run incremental cost of such service.

December 22 Order at 4-5. In addition, a subsidy analysis is relevant to the Ratepayer Advocate's proposal to maintain the existing basic residential rate and effectuate a rate reduction by applying this rate to larger local calling areas. *Supra* Sections III.A-.B.

In analyzing the subsidy analyses presented, the Board should ensure that the analysis it endorses provides a real-world, cost-based approach, not an artificial, restrictive approach. As will be shown below, when the proper analysis is used (even relying on Verizon-NJ's flawed total service long-run incremental cost ("TSLRIC") numbers), the inescapable conclusion is that residential service is *not* subsidized. Rather, it provides a **[BEGIN VERIZON**

**PROPRIETARY]** **[END VERIZON PROPRIETARY]** contribution.[15]
Accordingly, the Board can require the rate reduction called for by expanding local calling areas, *supra* Section III.B., while maintaining the existing $8.19 basic residential service rate and without subsidizing basic residential service. Selwyn Direct at 61-62.

#### 1. The Board Should Reject Verizon-NJ's Subsidy Analysis Because It Is Fundamentally Flawed

Verizon-NJ's claim that basic residential service is subsidized relies on a fundamentally flawed analysis. Selwyn Direct at 48-54. While Verizon-NJ is correct that a service is subsidized if it is provided at rates that generate revenues below its long-run incremental costs, Matt-Meacham-Prosini-Taylor Direct at 5, 9-10; Selwyn Direct at 46, when calculating TSLRIC it is essential that the proper costs and revenues be examined. Selwyn Direct at 49-53. In particular, *all* of the costs and revenues associated with the provision of residential service must be included in the cost subsidy analysis. Selwyn Direct at 49-53; *see also* T.81:3-6 (8/13/01) ("when revenues for all services sold over phone lines are taken into account, local service more than pays for itself," remarks of Ms. Marilyn Askin, President, AARP New Jersey).

Verizon-NJ, however, fails to apply this approach. Instead, Verizon-NJ analyzes only a limited set of specific rate elements associated with its provision of residential service. Matt-Meacham-Prosini-Taylor Direct at 11; Meacham-Prosini-Taylor-Gansert Rebuttal at 29-30; Selwyn Direct at 48-50. Verizon-NJ expressly excludes from its subsidy calculation revenues that it receives from the very same residential customers that order basic residential service. Meacham-Prosini-Taylor-Gansert Rebuttal at 29-34; Selwyn Direct at 48-50. Specifically,

[15] Selwyn Direct at 55-62. This figure is calculated as shown in Selwyn Direct at 62, by using the adjusted figure from Mr. Rothschild's supplemental testimony. *See supra* note 6.

Verizon-NJ excludes all costs and revenues associated with vertical features, intraLATA toll, switched access and non-published directory listings. Yet, Verizon-NJ only receives orders for these services because the residential customer also subscribes to Verizon-NJ's tariffed Residential Basic Exchange Service. Selwyn Direct at 49-50; Meacham-Prosini-Taylor-Gansert Rebuttal at 29-30; T.1482:2-23 (09/10/01); *see* T.1488:3-1490:11 (09/10/01).

It is not surprising that Verizon-NJ seeks to exclude these low-cost services, while including the single most costly item – the local loop – in its subsidy analysis. For example, Verizon-NJ witness Taylor testified that "[t]he forward-looking incremental cost of most vertical services is very small." T.808:19-20 (09/10/01); *see also* T.959:10-22 (8/31/01). By excluding these services, Verizon-NJ is simply acting according to its corporate incentives. As witness Taylor accurately stated, "Verizon [NJ]'s incentive is to behave under the rules of the price caps in a way that maximizes profits. So, recovering costs is a good thing, but maximizing profits is even . . ." better. T.988:24-989:5 (8/31/01).

Verizon-NJ acted upon this corporate incentive by proposing an artificial, misguided basic residential service categorization based solely on Verizon-NJ's tariffs for purposes of calculating the unrelated alternative regulation subsidy analysis. *See* Selwyn Direct at 48-50.

> According to Verizon-NJ Tariff B.P.U.-No. 2, Exchange and Network Services, Section A5.2.1, Basic Exchange Service, "[b]asic exchange service is a telecommunications service furnished to individual line business and residence customers and to party line residence customers within a specific geographic area for the purpose of local calling on either a flat rate or measured basis, and to gain access to and from the telecommunications network for message telecommunications service." . . . [Therefore, b]y definition, Residence *Basic* Exchange Service does not include vertical services, toll services and non-published listings. . .

Meacham-Prosini-Taylor-Gansert Rebuttal at 29 n. 17, 29-30. Having first assumed that its tariff definition is the starting point for the cost subsidy analysis, Verizon-NJ seeks to end the analysis there. Indeed, one Verizon-NJ witness expressly testified that the only relevant subsidy inquiry is: "as the provider of Residential [B]asic Exchange, essentially the Dial Tone line and local usage, is that service being subsidized by other services?" T.1579:4-7 (09/10/01).

In essence, Verizon-NJ is attempting to wrest from the Board the ability to determine the appropriate residential subsidy analysis by requiring that the analysis be directly tied to Verizon-NJ's own tariff definitions. Yet, tariffs have no direct bearing on a cost subsidy analysis. Rather, a tariff is simply the rates, terms and conditions under which a carrier offers a service or services. *See* Harry Newton, *Newton's Telecom Dictionary*, 16th Expanded and Updated Edition at 872 (2000) ("Newton's Telecom Dictionary"). That Verizon-NJ happens to have a tariffed service titled "Residential Basic Exchange Service" is irrelevant to the proper subsidy analysis. Verizon-NJ could name its tariffed services and propose their terms and conditions as it desires. These unilateral and often arbitrary determinations have no relation to a cost subsidy analysis. Thus, Verizon-NJ should not be permitted to use its ability to control its tariffs to unilaterally dictate the cost subsidy analysis.

Moreover, Verizon-NJ admits that very few residential customers desire to subscribe to only dial tone service. West-Taylor Direct, Exh. 7 at 15.[16] In fact, less than **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** of Verizon-NJ's

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[16] In addition to dial tone service, Verizon-NJ includes touch-tone, the state discount and the federally mandated subscriber line charge (SLC) in its analysis. Matt-Meacham-Prosini-Taylor Direct at 11-13. The Ratepayer Advocate agrees that these rate elements should be included in the residential service cost subsidy analysis. Selwyn Direct at 51.

residential customers do not subscribe to any vertical features. RPA Exh. 35, VNJ-RPA 102. Even Verizon-NJ would prefer not to offer stand-alone dial tone service – "Verizon-NJ recommends that the Board refrain from requiring a basic service option of stand-alone dial tone service. . . ." West-Taylor Direct, Exh. 7 at 15. Thus, Verizon-NJ would have the Board support a cost subsidy analysis based on a tariffed service that is ordered on a stand-alone basis by very few residential customers, and that Verizon-NJ argues it should not even offer on a stand-alone basis. The Board should reject such an analysis.

### 2. The Board Should Endorse the Ratepayer Advocate's Residential Service Cost Study Analysis Because It Is the Only Real-World, Economic Cost-Based Analysis

The Board should endorse the real-world, economic cost-based residential subsidy analysis sponsored by the Ratepayer Advocate. The Ratepayer Advocate's analysis does not simply look at the rate elements that comprise Verizon-NJ's tariffed offering. Instead, the Ratepayer Advocate's analysis examines all of the revenues and costs that follow from being a residential customer's local exchange carrier. Selwyn Direct at 49-63; Selwyn Supplemental at 12-14; T.1482:2-23 (09/10/01). For example, revenues from vertical features, intraLATA toll, switched access and non-published listings should be included in the cost subsidy analysis because none of these services exist independent of the customer ordering residential dial tone service. Selwyn Direct at 49-51; *see also* T.1488:3-1490:11 (09/10/01). By definition, since these services have no independent existence in practice, they will never be ordered by a residential customer that has not already ordered dial-tone service. T:1482:2-23 (09/10/01).

> From an economic standpoint, when assessing the relationship between revenues and costs for residential service, it is necessary to address *all* sources of revenues and costs that follow from being a residential customer's chosen local service

> provider, rather than, as [Verizon-NJ] has done here, to focus narrowly upon the revenue/cost relationships associated with individual rate elements in isolation. In fact the various rate elements associated with basic residential service were never set in relation to their individual respective cost, and in that sense [Verizon-NJ's] "analysis" can at best be described as proving something that is both obvious and of no particular interest or relevance. In addition to the dial tone line, usage, touchtone and the SLC, it is appropriate to include in a subsidy analysis such items as vertical features, intraLATA toll service, switched access, and non-published Listings.

Selwyn Direct at 50-51. Accordingly, the costs and revenues associated with these services, just as those associated with dial-tone service, are an integral part of any complete cost subsidy analysis. *Id.* at 49-51.

In fact, in its reclassification petition, Verizon-NJ implicitly recognizes the validity of including the costs and revenues of these additional services in calculating whether there is a residential service cost subsidy. *Id.* at 51. Specifically, Verizon-NJ includes vertical features as components of local switching and of business local exchange service in its reclassification petition. *Id.* at 51. Just as it is proper to include vertical features as part of business local exchange service, so should vertical features – and all other non-independent services associated with residential service – be included in the residential service subsidy analysis. *Id.* at 51.

Once the appropriate universe of costs and revenues is determined, a proper TSLRIC[17] cost study will determine whether residential service is being subsidized. *See* Selwyn Direct at 46-48; Matt-Meacham-Prosini-Taylor Direct at 5-5, 9-10. When comparing the monthly per-line

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[17] Because, except for joint and common costs, the TSLRIC study proposed by Verizon-NJ in this proceeding relies upon the same methodology as the total element long-run incremental cost ("TELRIC") study sponsored by Verizon-NJ in the unbundled network elements proceeding (Docket No. TO00060356), the same modifications ordered by the Board in its December 17, 2001 order (other than those applying solely to joint and common costs) should be made to the TSLRIC study. December 17 UNE Order at 3-12; *see also* Selwyn Direct at 57-59. However, since all testimony and cross-examination occurred before this order was issued, the Ratepayer Advocate has not had the opportunity to attempt to make these changes to the TSLRIC study.

direct costs of flat rate residential service, touch tone, the SLC, the state credit, vertical features and intraLATA toll services to the monthly revenues Verizon-NJ receives from these services, Verizon-NJ's own TSLRIC cost study numbers demonstrate that monthly revenues considerably exceed monthly TSLRIC costs. Selwyn Direct at 53; Matt-Meacham-Prosini-Taylor Direct at 14. Specifically, the revenues from these services exceed their total direct costs by **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** per month per line. Selwyn Direct at 53 (citing Matt-Meacham-Prosini-Taylor Direct at 14). When costs and revenues for switched access and for non-published listings are included, the monthly revenues exceed the direct costs by **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** per line. Selwyn Direct at 53-57 (internal citations omitted); Selwyn Supplemental at 12-14. Consequently, when residential service is properly defined, even using uncorrected Verizon-NJ input numbers, residential service is *not* being subsidized. Rather, even relying on Verizon-NJ's TSLRIC studies, residential service is generating a **[BEGIN VERIZON PROPRIETARY]** **[END VERIZON PROPRIETARY]** contribution.[18] Therefore, existing residential rates generate considerable excess revenues that are available to be used for a rate reduction. *See supra* Sections III.A.-B.

### D. The Board Should Establish a State Universal Service Fund and Require Verizon-NJ to Expand Its Universal Service Offerings

[18] This figure is calculated as shown in Selwyn Direct at 62, but using the adjusted figure from Mr. Rothschild's supplemental testimony. *See supra* note 6.

The 1992 Act requires that a plan for alternative regulation "ensure the affordability of protected telephone services."[19] 48 N.J.S.A. § 48:2-21.18(a)(1). Similarly, the 1996 Act requires that communications services "be available at just, reasonable, and *affordable* rates." 47 U.S.C. § 254(b)(1) (emphasis added). Notably, this was the first time that Congress ever expressly required that services be affordable. *See I/M/O the Investigation Regarding Local Exchange Competition for Telecommunications Services*, Docket No. TX95120631, Direct Testimony of Mark N. Cooper at 21 (filed Sept. 16, 1997) ("Cooper Universal Service Testimony")(Attachment 3). Verizon-NJ fails to demonstrate that residential telephone service will be affordable for all New Jersey consumers under its proposed plan of alternative regulation.

Verizon-NJ's Petition relies on the wrong criteria to evaluate affordability. Verizon-NJ bases its claim that service will be affordable on per capita income statistics. West-Taylor Direct at 10-12. According to Verizon-NJ, per capita income in New Jersey has increased one hundred one percent (101%) since 1985. West-Taylor Direct at 11. Verizon-NJ then asserts that, because basic residential service rates remained the same while per capita income has risen, residential service has become more affordable. West-Taylor Direct at 10-12; *see* Colton Direct at 3, 6.

The use of per capita income statistics presents only a partial and therefore inaccurate affordability picture. That picture is only complete when income data are viewed with more

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[19] New Jersey statutes define "protected telephone services" as:

> any of the following telecommunications services provided by a local exchange telecommunications company, unless the board determines, after notice and hearing, that any of these services is competitive or should no longer be a protected telephone service: telecommunications services provided to business or residential customers for the purpose of completing local calls; touch-tone service or similar service; access services other than those services that the Board has previously found to be competitive; toll service provided by a local exchange telecommunications company; and the ordering, installation and restoration of these services.

N.J.S.A. § 48:2-21.17.

granularity. Colton Direct at 4. This is borne out by the FCC's analysis, which determined that in analyzing universal service issues, affordability has a comparative (*i.e.*, relative) aspect as well as an absolute aspect. Colton Direct at 4; *Federal-State Joint Board on Universal Service*, 12 FCC Rcd 8776, CC Docket No. 96-45, FCC 97-157 ¶¶ 110-126 (1997) (internal citations omitted) ("FCC Universal Service Order"). When analyzed comparatively, "a rate that is affordable to affluent customers may not be affordable to lower-income customers." FCC Universal Service Order ¶ 115. On this basis, the FCC specifically rejected the "per capita" approach that Verizon-NJ's urges here.

> As the Joint Board concluded, determining affordability based on a percentage of the national median income would be inequitable because of the significant disparities in income levels across the country. Specifically, we agree with the Minnesota Coalition that such a standard would tend to overestimate the price at which services are affordable when applied to a service area where income level is significantly below the national median.

*Id.*

Using a comparative analysis demonstrates that while residential telephone service has become more affordable for wealthier consumers, it has become less so for the poor. For example, the poorest twenty percent (20%) of New Jersey households had their incomes decline 7.1% from the years 1988-1990 to the years 1996-1998, with the result that residential service became comparatively more expensive for those households. Colton Direct at 7.

To offset this relative increase in the cost burden of residential service to the poorest New Jersey consumers, the Board should order the improvements to the Verizon-NJ proposed universal service mechanisms detailed by the Ratepayer Advocate in the Direct Testimonies of Messrs. Colton and Weiss and explained below. The Ratepayer Advocate has consistently

proposed these state universal service improvements to the Board at least as far back as the Board's initial attempt to implement the 1996 Act. *Investigation Regarding Local Competition for Telecommunications Services*, Docket No. TX95120631. Because the Board has yet to conclusively rule on these matters and because universal service issues are necessarily implicated by the Board's review of Verizon-NJ's proposed plan of alternative regulation, the Ratepayer Advocate reiterates them again here.

#### 1. The Board Should Adopt State Universal Service Programs that Will Ensure that Low-Income Residents, Schools and Libraries and Residents Located in High Cost Areas All Are Able to Receive Affordable Communications Services in a Competitive Environment

The 1996 Act specifically requires that federal universal service programs be established to enable access to affordable telecommunications and information services by (1) low-income residents, (2) schools and libraries and (3) residents living in high cost (including rural and insular) areas. 47 U.S.C. §§ 254(b)(1)-(3), (h)(1)(B), (h)(2). The FCC, in coordination with the Federal-State Joint Board on Universal Service, established federal universal service funds ("USFs") to achieve these goals. *See, e.g.,* FCC Universal Service Order.

The federal USF, however, is insufficient to ensure that New Jersey residents and schools and libraries have access have access to affordable intrastate telecommunications and information services. The federal USFs, by definition, can only apply to interstate services. *See, e.g.*, 47 U.S.C. § 254(g). Moreover, the funding for the federal programs (except for a limited portion of the Lifeline program, *infra* Section III.D.2.) lies outside the control of the Board. This places any New Jersey resident or school or library that relies on federal funds at risk if such funds are not allocated. *See* Consumer Energy Council of America Report, *Universal Service Policy Issues for*

*the 21st Century* at 15, 23. For example, eligible New Jersey schools and libraries have been denied federal E-rate funding. Colton Direct at 31-33; *infra* Section III.D.1.b. Finally, many New Jersey schools and libraries face situations that may be unique to New Jersey and therefore would not be sufficiently addressed solely by federal programs. For instance, an unusually large percentage of New Jersey schools contain asbestos in their walls that considerably increases the costs of wiring the schools to receive advanced services. Colton Direct at 28-30; *infra* Section III.D.1.b.

Accordingly, it is critical that the Board establish an independently administered state USF to ensure that low-income residents, schools and libraries, and residents in high cost areas receive affordable intrastate telecommunications and information services. Congress expressly included a provision in the 1996 Act contemplating that states would supplement the federal USF with state USFs: "A State may adopt regulations not inconsistent with the [FCC's] rules to preserve and advance universal service." 47 U.S.C. § 254(f). Further, the independent administration of such a fund would be consistent with New Jersey's energy Lifeline fund, which is administered by the New Jersey Department of Health and Human Services. *I/M/O the Establishment of a Universal Service Fund Pursuant to Section 12 of the Electric Discount and Energy Competition Act of 1999*, Docket No. EX00020091, Energy Interim Order ¶ 3 (Nov. 21, 2001) ("NJ Energy USF Order"). Specifically, the New Jersey state USF should:

- Provide for basic local telephone service to low-income consumers at reduced rates and assist low-income consumers in paying the local service portion of unpaid telephone bills incurred prior to the adoption of the state USF;
- Provide funding for advanced telecommunications services and equipment, including interactive video and data services and equipment, to schools and libraries;

- Provide for local rates for schools and libraries at the same level as paid by residential local exchange customers; and

- Provide funding to telecommunications carriers providing services in high cost areas of New Jersey.

*See* Colton Direct at 22-40; Weiss Direct at 17-21; Weiss Supplemental at 4. Funding for the state USF should be paid for by each telecommunications carrier as a percentage of gross intrastate revenues from all intrastate telecommunications services. *See* Colton Direct at 39-40.

#### a. The State USF Should Include a Component for Low-Income Residents

To ensure the availability of affordable telecommunications services to New Jersey's poorest residents – residents whose incomes in real terms have been declining significantly, *supra* Section III.D. – the New Jersey state USF should include a component for low-income residents. Cooper Universal Service Testimony at 5, 24. Such a component is necessary in a state program, as Dr. Mark Cooper explained in the 1997 universal service proceeding, "as a means of ensuring the affordability of telephone service for all residents of the state." Cooper Universal Service Testimony at 5. In particular, a state low-income USF component is necessary to respond to conditions unique to New Jersey's low-income residents.

This need for a low-income state universal service program parallels the need for the establishment of GPU's PIP Pilot Program to support affordable energy services, which was recently adopted by the Board. NJ Energy USF Order at 20, 23-25. Specifically, in endorsing that new energy program, the Board found it necessary even though other programs already existed to provide low-income residents with assistance in affording gas and electricity.

> Although [energy] Lifeline, LIHEAP, NJ SHARES, Gift of Warmth, TLC, CRA, and Winter Termination programs are all available to assist those customers who

> require either long-term or short-term assistance with their gas and electric bills, the record in the USF proceeding clearly indicates that additional resources need to be made available to assist customers who are unable to afford their utility bills.

NJ Energy USF Order at 20. Just as there is a need to supplement existing energy assistance programs in the energy universal service proceeding, so too there is a need to supplement the federal Lifeline support for low-income residents, *infra* Section III.D.2., by creating a state USF that includes a component that provides assistance to low-income New Jersey residents.

The low-income component of the state USF should enable low-income consumers to apply USF assistance towards obtaining "basic universal service," which would include: touch tone, voice grade service; unlimited local calling area privileges; access to emergency and directory service; a white page listing and the ability to block or otherwise limit toll services. Enrollment of low-income consumers into the state USF program should be (1) automatic (unless the consumer opts-out) for recipients of benefits under the public assistance programs currently used to determine Lifeline eligibility, and (2) granted upon self certification by those households with incomes at or below 175% of the federal poverty level similar to recent NJ Energy USF Order. In fact, the National Association of Statue Utility Consumer Advocates has recommended that the FCC add stand alone income eligibility criteria for Lifeline and link-up, adopt policies favoring automatic enrollment, and adopt policies ensuring program outreach. *Federal-State Joint Board on Universal Service*, Memorandum Opinion and Order, CC Docket No. 96-45 (October 12, 2001). Finally, similar to the NJ Energy USF Order, the low-income component of the state USF should include an arrearage program that would permit a low-income state USF participant time to pay the portion of an outstanding bill that pertains to services equivalent to basic universal service (as defined above).

### b. The State USF Should Enable Schools and Libraries to Obtain Affordable Advanced Telecommunications Services Wherever They Are Located and from Any Service Provider

In addition to ensuring that low-income residents have access to affordable telecommunications services, the Board should also ensure that schools and libraries throughout New Jersey have access to advanced telecommunications services and equipment, including interactive video and data services. Access to such services and equipment, such as digital subscriber line ("DSL") services and equipment,[20] is crucial to the task of educating New Jersey's youth.

> Affordable access to technology and telecommunications services for every school and library in New Jersey is essential for ensuring that New Jersey's students can succeed in the increasingly technological world marketplace.

Osowski Direct at 3. Indeed, such access is called for by the Telecommunications Act of 1996:

> Elementary and secondary schools and classrooms . . . and libraries should have access to advanced telecommunications services . . ."

47 U.S.C. § 254(b)(6).

In recent years, New Jersey has pursued this objective through the Access New Jersey ("ANJ") program, *see* Osowski Direct at 4, 10-11, which enables schools and libraries to obtain advanced services at special discounted rates. Colton Direct at 22-23; Weiss Direct at 8-9. However, this program was scheduled to expire at the end of 2001, and it only pertains to services provided by Verizon-NJ in its service territory. To ensure that New Jersey schools and libraries can acquire affordable advanced services, the Board required that any plan of alternative regulation contain:

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[20] The FCC has found that "advanced services" expressly include "services that rely on digital subscriber line technology (commonly referred to as xDSL)." *Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 98-147, 98-11, 98-26, 98-32, 98-78, 98-91 and CCB/CPD No. 98-15, FCC 98-188, Memorandum Opinion and Order, and Notice of Proposed Rulemaking ¶ 3 (1998) (footnote omitted).

> a specific proposal for the continuation of the existing Access New Jersey (ANJ) program beyond the year 2001 including, but not limited to, the expansion of the services currently offered under the plan.

December 22 Order at 5; *see also* RPA Exh. 57, VNJ-RPA 377.

Continuing and expanding the ANJ program, as well as developing similar programs for schools and libraries outside of Verizon-NJ's service territory and for competitive carriers to be able to offer equivalent discounted advanced services and equipment, such as DSL, are vital to meeting New Jersey's educational goals. *See* RPA Exh. 57, NJSBA-RPA 6. Affordable access to advanced telecommunications services and equipment is needed if the state is to meet the New Jersey Department of Education's "vision and benchmarks" for technology education. Thus, an expanded ANJ program and new analogous programs for other incumbent carriers and for competitive carriers will help ensure that:

> 1. Educational technology will be fully infused into the schools' curriculum and instruction. . . . For example, computers will be fully integrated into all classrooms for instructional purposes, rather than maintained solely in a computer laboratory environment.
>
> 2. All classrooms will have fast and reliable Internet access.
>
> 3. All districts, schools and classrooms will be connected to high-speed voice, video and data networks.
>
> 4. All school buildings will have the equipment and infrastructure necessary to provide distance learning opportunities for all students.
>
> 5. All school districts will have the equipment necessary to access satellite transmissions.
>
> 6. All school construction projects (new and retrofitting) will include a backbone distribution system, communications outlets in each room, and wiring closets in each school thus enabling schools to establish the infrastructure for a technology-rich environment.

Colton Direct at 24-25 (quoting New Jersey Department of Education, Educational Technology in NJ, Vision and Benchmarks by 2002). Meeting these benchmarks is important because there is a direct correlation between technology access and grade improvement. Osowski Direct at 10-11; RPA Exh. 57, NJDOE-VNJ 2.

Today, too few classrooms and school libraries have broadband Internet access, such as DSL.[21] Colton Direct at 28-31; Weiss Direct at 6, 14-15; *see also* RPA Exh. 57, NJSBA-RPA 6. Due to unique characteristics of some of New Jersey's schools and libraries, it is unusually costly for them to make the building infrastructure changes necessary to utilize advanced telecommunications services. Colton Direct at 28-31. For example, forty-one percent (41%) of schools statewide are over 50 years old and often contain asbestos in the walls, thereby making it extremely expensive to place the wiring necessary to reach classrooms. Colton Direct at 28-30. Additionally, access to federal E-rate money is limited and many New Jersey schools and libraries have been denied E-rate funding. Colton Direct at 31-33. Thus, aid in the form of discounted services and equipment is critical to making advanced services and equipment affordable to schools and libraries. *See* RPA Exh. 57, NJSBA-RPA 6.

As an initial matter, programs similar to the ANJ program should be created (1) to service schools and libraries located outside of Verizon-NJ's service territory, and (2) for provision by competitive carriers. First, although Verizon-NJ is the predominant ILEC in New Jersey, it is not the sole carrier. For example, United Telephone and Warwick Valley Telephone also provide local exchange service in some parts of New Jersey. Because ANJ only applies to services and

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[21] Advanced services need to be brought to the individual classrooms, not just to the school buildings. *See* RPA Exh. 57, NJDOE-RPA 1.

equipment offered by Verizon-NJ (T.1183:12-21 (8/31/01)) schools and libraries located in the territories of other incumbent carriers are unable to receive the discounts available under the ANJ program. There is no reason that schools and libraries in some parts of New Jersey should have discounted advanced services and equipment available to them, while schools and libraries in other parts of the state do not have access to such discounted services and equipment.

Second, competitive carriers should also be afforded the opportunity to provide discounted advanced services and equipment to schools and libraries. Competitive carriers, such as XO New Jersey, Inc., seek entry into this market. *See* T.1183:4-21 (8/31/01); *see also I/M/O the Consultative Report on the Application of Verizon New Jersey Inc. For FCC Authorization to Provide In-Region, InterLATA Service in New Jersey*, Docket No. TO01090541, Initial Brief of XO New Jersey, Inc. at 26-27 (filed Dec. 7, 2001). Schools and libraries should be permitted to enjoy the benefits of competition – better and cheaper services – that multiple carriers should provide. Therefore, establishing a state USF would enable competitive carriers to provide the same or equivalent discounted services and equipment to New Jersey schools and libraries as those that Verizon-NJ provides under the ANJ program.

With respect to the Verizon-NJ ANJ program, Verizon-NJ's proposal to continue the program only to 2004 and to invest $20 million annually in the program is insufficient to achieve the educational goals of New Jersey's schools, as noted by the Department of Education (see above). West-Taylor Rebuttal at 39-41; *see* Colton Direct at 37. Verizon-NJ has provided no indication that New Jersey's schools and libraries can obtain needed advanced services and equipment during the period from the present until 2004. *See* Osowski Supplemental at 2. Additionally, $20 million is insufficient to accomplish these goals. Osowski Supplemental at 2.

Instead, the Board should adopt the Ratepayer Advocate's recommendations on the ANJ program. Colton Direct at 22-27; Weiss Direct at 1-21. First, the financial commitment to the ANJ program should be increased to $47 million annually. Colton Direct at 37; *see* Osowski Supplemental at 2-3 (advocating $50 million annually). Second, educational discounts for all services and equipment should be maintained, Colton Direct at 34, should apply to all advanced services and equipment, including DSL, and discounts for Asynchronous Transfer Mode ("ATM") services should be deepened. Colton Direct at 34-35; Weiss Direct at 8, 10, 17-19. ATM services are particularly effective in providing schools and libraries with access to broadband Internet access. It is therefore particularly important that discounts for ATM services and equipment be sufficient to enable schools and libraries to obtain ATM services. Colton Direct at 34-36; Weiss Direct at 8, 10, 17-19.

Third, services for schools and libraries should be priced based on existing residential service tariffs rather than business service tariffs. Weiss Supplemental at 4. Finally, the ANJ program should not contain a sunset date. Colton Direct at 34; *see also* Osowski Direct at 11-12 (continue ANJ though 2010). The education of New Jersey's students is simply too important to permit the ANJ program to sunset. Colton Direct at 34.

#### c. The State USF Should Include a Component to Encourage Competition in High Cost Areas

New Jersey needs a universal service high cost fund. Colton Direct at 37-40. Without such a fund, the benefits of competition will not accrue to all New Jersey consumers, in particular those in high cost, generally rural, areas. *Id.* at 37-38, 40. Such a fund will provide needed incentives for competitors to provide service in these areas. *Id.* at 37-38, 40.

Because a high cost fund will encourage competition where it would otherwise not exist, Verizon-NJ, not surprisingly, opposes its creation. *See* West-Taylor Rebuttal at 47-48; West-Taylor Direct at 27. Yet, Verizon-NJ offers no proposal of its own that will bring competition and all its associated benefits to high cost areas of New Jersey.

The Board should adopt the Ratepayer Advocate's high cost fund proposal as set forth in the Direct Testimony of Mr. Colton. Colton Direct at 37-40. Under this proposal the areas eligible for support would be those served by wire centers with costs that exceed twice the statewide average price for local exchange service. *Id.* at 38. Telephone subscribers in those areas would be eligible for an average monthly assistance of $2.08, payable directly to the local telecommunications provider. *Id.* at 39.

### 2. The Board Should Enable New Jersey Consumers To Receive Full Lifeline Benefits And Improve Lifeline Eligibility Criteria And Processes

In addition to establishing an independent state USF, the Board should improve the affordability of residential service by ordering improvement to the New Jersey Lifeline program. Lifeline is a federal program designed to promote universal service by giving low-income persons credits toward the purchase of basic residential telephone service. *See* Newton's Telecom Dictionary at 513-514. To enroll in the current Lifeline program in New Jersey, a consumer must participate in one of the following public assistance programs: Food Stamps; Temporary Aid to Needy Families; Medicaid; the Low-Income Home Energy Assistance Program; state or federal public housing; Section 8 assisted housing; or Supplemental Security Income. Colton Direct at 10; *see also* West-Taylor Direct at 21; T.877:4-11 (8/30/01). Eligible participants currently may receive up to $7.00 in assistance towards their residential service. *See* Colton Direct at 9-10, 15.

Verizon-NJ proposes only limited improvements in its Lifeline program. Verizon-NJ would (1) enable senior citizens 65 years of age or older and with incomes under one hundred fifty percent (150%) of the federal poverty level to enroll in the program even if they do not participate in any of the delineated public assistance programs, and (2) establish a self-certification mechanism for enrollment. West-Taylor Direct at 13, 22-24; West-Taylor Rebuttal at 36-37; T.881:2-14, 885:12-18 (8/30/01). Verizon-NJ does not propose any change in the amount of the Lifeline credit. West-Taylor Rebuttal at 37. It also opposes instituting an automatic enrollment process. *Id.* at 37-38.

#### a. The Lifeline Program Should Afford Eligible Consumers the Maximum Level of Assistance Available

New Jersey consumers that qualify for the Lifeline program should be able to gain the full benefit of federal Lifeline assistance. *Id.* at 9-10, 15. Under the federal program, the maximum possible assistance is $10.50 per month. *Id.* at 9-10. Because of the level of Verizon-NJ's contribution to the current program and the program as proposed by Verizon-NJ, however, New Jersey consumers only receive $7.00 of federal assistance. *Id.* at 9-10; *see* T.897:6-898:10 (8/30/01). Other state commissions, such as the New York Commission, have required that Verizon provide sufficient contributions to their state lifeline program so that eligible ratepayers may receive up to the maximum $10.50 in monthly assistance. See RPA Exh. 30; T.897:2-899:16 (8/30/01). New Jersey consumers are just as deserving of full support as are citizens of other states, such as New York. RPA Exh. 30; *see* T.897:2-899:16 (8/30/01). Thus, the total Lifeline benefit should be increased by $3.50 to ensure the maximum amount of federal Lifeline support.

**b. Any Household with an Income Less than or Equal to 175% of the Federal Poverty Level Should Be Eligible to Participate in the Lifeline Program**

To increase the level of subscribership in the Lifeline program as the Board envisions (December 22, 2000 Order at 5) the eligibility standards should be broadened to include a maximum household income criteria. Colton Direct at 11-12. All households with income at or below one hundred seventy-five percent (175%) of the federal poverty level should be eligible for the Lifeline program. *Id.* at 13. Because the poorest twenty percent (20%) of New Jersey residents have had their income decline in absolute terms and in comparison to the incomes of wealthier New Jersey citizens, and because fifteen and one-half percent (15.5%) of all New Jersey residents (513,000 households) have incomes below 175% of the federal poverty level, permitting these consumers to enroll in the Lifeline program will enable the consumers for whom residential service has become less affordable to participate in the program. *Id.* at 7, 14; *see id.*, Sch. RDC-8; *see also* T.99:21-100:9 (8/13/01) (remarks of Ms. Staci Berger , New Jersey Citizens Action, stating that the proper eligibility level may be as high as 225%). This is particularly important because telephone penetration rates decline once families earn less than $20,000. Colton Direct at 7-8 (citing Jorge Schement, *Beyond Universal Service: Characteristics of Americans Without Telephones, 1980-1983* (Rutgers University 1996)).

Expanding the eligibility to participate in the Lifeline program to include all households with incomes below 175% of the federal poverty level would be consistent with the Board's recent action in the energy industry to establish the PIP Pilot Program. NJ Energy USF Order at 20. Specifically, the Board held that "GPU's PIP Pilot Program shall initially be applicable to customers with incomes at or below 175% of [the federal] poverty level." *Id.* Moreover, the

Board accepted this criterion in full awareness of the numerous other low-income energy assistance programs in place. *Id.* Thus, just as the Board promoted universal service for gas and electric services by establishing eligibility for the PIP Pilot Program based on incomes under 175% of the federal poverty level, the Board should directly promote affordable, universal telecommunications service by expanding the eligibility criteria to include all households with incomes under 175% of the federal poverty level.

### c. The Lifeline Enrollment Process Should Be Improved and Simplified, and Should Include an Automatic Enrollment Procedure

To simplify the Lifeline enrollment process and encourage greater participation by eligible consumers, the Board should endorse the Ratepayer Advocate's proposal to increase enrollment flexibility. December 22 Order at 5; Colton Direct at 10-13, 16-19. Currently, only 41,000 households are enrolled in the Lifeline program in New Jersey. T.23:5-6 (04/13/01); T.82:22-83:11 (8/13/01); T.97:16-98:5 (8/13/01). To increase enrollment, the Board should require incumbent carriers to take proactive steps to increase participation. Incumbent carriers should be required, as are providers in the energy industry, to have their customer service representatives inform eligible participants of their eligibility. NJ Energy USF Order at 24.

Further, the Lifeline enrollment process should be greatly simplified. Consumers eligible because of their participation in the appropriate public assistance program should be automatically enrolled in the Lifeline program. Colton Direct at 10-12, 16-17. To account for eligible consumers who are not in assistance programs that would lead to automatic enrollment, self-certification to Verizon-NJ should also be an option to enroll in Lifeline. West-Taylor Direct at 22-24; *see* Colton Direct at 16-17.

Automatic enrollment provides the simplest enrollment possible. Moreover, the FCC in effect required that it be available in its order approving the Bell Atlantic/GTE merger. There, the Commission required all Verizon state affiliates, including Verizon-NJ, to offer a Lifeline plan consistent with the Ohio Universal Service Assistance (USA) Lifeline plan ("Ohio Plan"). *Application of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee for Consent to Transfer Control of Domestic and International Sections 214 and 310 Authorizations*

*and Application to Transfer Control of a Submarine Cable Landing License*, 15 FCC Rcd 14032, CC Docket No. 98-184, FCC 00-221, Memorandum Opinion and Order ¶¶ 325-326, Conditions for Bell Atlantic/GTE Merger ¶ 50 (2000) ("GTE FCC Merger Order" and "GTE FCC Merger Conditions").

**The Ohio Plan contains an automatic enrollment feature.** Colton Direct at 10-12, 16-17; *Application of Ameritech Ohio (Formerly Known as the Ohio Bell Telephone Company) for Approval of an Alternative Form of Regulation*, Ohio PUC Case No. 93-487-TP-ALT, Opinion and Order at 7-8 (2000). Verizon is also offering automatic Lifeline enrollment in other states, including New York. Colton Direct at 10-11; T.82:22-83:11 (8/13/01). In states with automatic enrollment, participation in Lifeline programs is, not surprisingly, significantly higher than in New Jersey. Ms. Marilyn Askin, President of AARP New Jersey, clearly explained the reasons the Board should order automatic enrollment in her remarks before the Board:

> Here's why automatic enrollment makes so much sense. Previous outreach attempts to sign up New Jersey's low-income population haven't worked. Less than 45,000 households currently receive the $7.00 per month Lifeline credit on their telephone bills. Compare that to New York's over 600,000 Lifeline recipients. Why the huge difference? New York uses automatic enrollment. We believe approximately 300,000 low-income New Jersey families are missing out on Lifeline because of the absence of automatic enrollment. . . .
>
> Thus, AARP calls on the BPU to issue an Order requiring automatic enrollment as soon as possible.

T.82:22-83:11, 87:18-20 (8/13/01).

Finally, the Board has endorsed automatic enrollment processes for low-income assistance programs in the energy industry. NJ Energy USF Order at 21. Just as automatic enrollment is the most efficient means for customers to enroll in the PIP Pilot Program, so too is it the most efficient means for customers to enroll in the telecommunications Lifeline assistance program.

### (1) The Board Should Reject Verizon-NJ's Baseless Objections to Automatic Enrollment

Verizon-NJ's objections to an automatic enrollment process are without merit. Verizon-NJ's claim that the Board ordered Verizon-NJ not to implement automatic enrollment misreads the Board's Opportunity New Jersey Order and that Order's relationship to the GTE FCC Merger Order and GTE FCC Merger Conditions. West-Taylor Rebuttal at 37-38; *The Board's Inquiry into Bell Atlantic-New Jersey, Inc.'s Progress and Compliance with Opportunity New Jersey, as Accelerated by Order Dated June 10, 1997*, Docket No. TX99020050, Telecommunications Order of Approval (rel. March 30, 2001) ("Opportunity New Jersey Order"). In the Opportunity New Jersey Order, the Board did not affirmatively order that automatic enrollment not be adopted. Rather, in "memorializ[ing] actions taken by a vote of three Commissioners at the December 7, 1999 and December 22, 1999 public meetings of the Board," the Board simply declined to adopt automatic enrollment at that time. Opportunity New Jersey Order at 1, 9. Moreover, since the Opportunity New Jersey Order formalized the Board decisions adopted in 1999, it could not have accounted for the subsequently adopted GTE FCC Merger Order and GTE FCC Merger Conditions.

Verizon-NJ's attempts to distinguish New Jersey from New York, which utilizes automatic enrollment, are similarly unpersuasive. Verizon-NJ's witnesses venture beyond their competence to claim, erroneously, that New Jersey privacy law prevents the implementation of automatic enrollment. West-Taylor Rebuttal at 38. Despite numerous requests to identify the specifics of this privacy concern, Verizon-NJ has been unable to substantiate this claim. T.911:18-912:12 (8/30/01); *see also* West-Taylor Rebuttal at 38. Rather, according to AARP

New Jersey, the New Jersey Attorney General's office has never provided Verizon-NJ with written advice on this issue.

> Verizon[-NJ] has argued that they cannot be given access to PAAD state agency data, on advice from the DAG [Deputy Attorney General].
>
> That is based on a conversation they say they had with the PAAD/lifeline Director Wade Epps. I recently saw an exhibit which I can provide you, a data request I believe from the Ratepayer Advocate asking one of the witnesses testifying in the case what are the documents behind your [Verizon-NJ] saying that the DAG does not permit this data to go to Verizon[-NJ]?
>
> Well, the response that came through was an internal memo and it said that the conclusion was based [on] a conversation they had with the PAAD Lifeline Director Wade Epps. Well, I know Wade Epps and when I saw that today I called Wade Epps, spoke to him about 3:30 this afternoon. He said there has been no written decision made on the case, and he is the Director of the Program.

T.51:3-22 (10/01/01) (statement of Mr. James Dieterle, State Director, AARP New Jersey).

Verizon-NJ further offers no viable reason why Verizon-NY (or more specifically its predecessor, NYNEX) both sought and obtained approval to utilize an automatic enrollment process in New York, T.910:22-911:2 (8/30/01), and yet Verizon-NJ has failed to formally seek and obtain the same permission in New Jersey. Verizon-NJ merely offers the unsubstantiated claim that automatic enrollment works in New York because Verizon New York has a better relationship with the New York Health And Human Services agencies than Verizon-NJ has with the New Jersey Department of Human Services. T:1190:14-1191:9 (8/31/01); T.910:24-911:5 (8/30/01); *see* T.913:16-916:13 (8/30/01). Similarly, Verizon-NJ proffers no reason why electric and gas utilities in New Jersey are permitted to utilize data from the New Jersey Department of Human Services to automatically enroll Lifeline customers, and to perform enrollment in the PIP Pilot Program, Electric Interim Order at 21, but Verizon-NJ is not similarly permitted to use such

information for automatic Lifeline enrollment. *See* T.98:14-15 (8/13/01) (statement of Ms. Staci Berger, New Jersey Citizens Action: "LIHEAP enrollees are already computer matched"). Nor does Verizon-NJ explain how the federal Department of Health & Human Services could provide permission under the Privacy Act for Verizon-NY to implement automatic enrollment, Exh. RPA-32, yet this same federal government approval neither applies nor was sought for New Jersey. Verizon-NJ must not be permitted to skirt its Lifeline responsibilities merely because it claims to have poor relationships with New Jersey state agencies. Accordingly, Verizon-NJ's objections to automatic enrollment should be rejected by the Board.

### E. To Ensure Verizon-NJ Provides High-Quality Services to New Jersey Consumers, The Board Should Adopt the Ratepayer Advocate's Service Quality Measures, Standards and Self Effectuating Penalties for Poor Performance

The Board should approve the service quality measures, standards and self effectuating penalty mechanisms proposed by the Ratepayer Advocate because these proposals will create the proper incentives to ensure that Verizon-NJ provides the highest quality service to New Jersey consumers. For the Board to approve an alternative regulation plan, the Board must affirmatively find that the plan "contains a comprehensive program of service quality standards, with procedures for board monitoring and review." N.J.S.A. § 48:2-21.18(a)(7). In fact, in its December 22 Order, the Board required that any new alternative regulation plan contain

> a *new* comprehensive proposal of service quality standards that includes all applicable retail metrics contained in the Carrier-to-Carrier Guidelines approved by the Board Order dated July 13, 2000 at Docket Nos. TX95120631 and TX98010010; with new standards *at least as stringent as* those contained in the Carrier-to-Carrier Guidelines.

December 22 Order at 5 (emphasis added).

Thus, Verizon-NJ was required to propose a comprehensive service quality plan that was "sufficient to establish a *prima facie* case for compliance" with the December 22 Order and with the 1992 Act. December 22 Order at 7 (emphasis in original). Because (as shown below) Verizon-NJ failed to propose a new comprehensive service quality plan, it failed to comply with the statute or with the December 22 Order. Therefore, the Board should find the Verizon-NJ proposal deficient and take corrective action. December 22 Order at 8 ("If the filing does not contain all the requirements contained in this Order when filed . . . the filing will be deemed deficient and the Board shall take action as it deems appropriate."). The Ratepayer Advocate respectfully submits that adoption of its service quality standards and penalty mechanisms proposal will sufficiently cure Verizon-NJ's proposal (solely with respect to the individual service quality criteria).

### 1. The Board Should Reject Verizon-NJ's Service Quality Standards Proposal Because It Fails to Comply with New Jersey Statutes and Regulations

Verizon-NJ failed to propose a comprehensive service quality standards program. Instead, Verizon-NJ merely proposes the same service quality program that has been in place since 1987 – prior to the enactment of both the 1992 Act and the 1996 Act – adding only the absolute minimum set of metrics from the Carrier-to-Carrier Guidelines. Thoms Direct at 5-11 *see* Phillips Rebuttal at 3.

> The present system of service quality indices or "metrics" was initiated by the Board in November 1987, as part of Verizon-NJ's Rate Stability Plan and reexamined in 1993 when the Board approved an incentive regulation plan. The Board has not found it necessary to change these metrics and it should not do so now.

Phillips Rebuttal at 3. Proposing merely to maintain the existing plan is insufficient to meet the requirement that Verizon-NJ propose a *new*, *comprehensive* plan containing stringent performance standards. *See* December 22 Order at 5. For example, certain tasks that are critical to measuring Verizon-NJ's performance today, such as customer outages and percent installations met, were not part of the original 1987 metric plan. *See* Alexander Direct at 21-23, Exh. BA-3; *see infra* Section III.E.2. Similarly Verizon-NJ's plan contains no penalty provisions. *See id.* Thus, the Board should reject Verizon-NJ's proposal.

Verizon-NJ's proposal fails to recognize that service quality standards should not be static, but rather should evolve over time, a fact the Board recognized at least as long ago as 1993.

> Although the Board is satisfied that the present standards ensure a reasonable level of service, this is not to say that additional and/or more stringent standards may not be appropriate, especially as technology moves forward and the industry evolves.

1993 Order at 139. Instead, Verizon-NJ asserts that because it has largely met the service quality standards adopted fourteen years ago, service quality must be good and no changes to the existing standards (other than as embodied in the Carrier-to-Carrier Guidelines) are warranted at all.[22] Phillips Rebuttal at 3-6; Phillips Supplemental at 1-2; Thoms Direct at 5; T.1450:15-1451:6 (09/07/01).

Such a static view of service quality standards utterly defeats the purpose of such standards – ensuring continual and evolving high quality service – particularly in an industry

[22] It is not clear that Verizon-NJ has provided high quality service in recent years. For example, the average out of service repair interval rose 7.4 hours (from 26.3 to 33.7 hours) between 1996 and 2000. T.1380:3-12 (09/07/01); *see also* RPA Exh. 46, VNJ-RPA 1, 2.

changing as quickly as the telecommunications industry has in the last fourteen years. *See* Alexander Direct at 7-10. In such an industry, particularly one lacking sufficient competition to ensure a high level of service quality, it is critical that standards stimulate the service quality improvements that would occur in the marketplace but for the lack of competitive pressures. Indeed, the Maine Public Utilities Commission reached this very conclusion when ordering service quality standards in the context of addressing Verizon-ME's proposed plan of alternative regulation.

> [T]here is insufficient local exchange competition in Verizon Maine's service territory – and virtually none for its residential and small business customers – for the [Maine] Commission to rely on competition alone to cause Verizon Maine to maintain and improve its service quality. . . . [M]ost CLECs in Maine rely in whole or in part on the quality of Verizon Maine's services and facilities to provide local exchange service to their customers.

Maine Alt Reg Order § E. Verizon-NJ has acknowledged the evolutionary nature of the telecommunications industry in New Jersey in its reclassification petition. PAR-2 Petition at 4 ("This petition reflects the continuing evolution of this state's telecommunications market place"). Nevertheless, Verizon-NJ adamantly objects to improvements to the existing service quality standards. *See* Phillips Rebuttal at 3, 5-20; Phillips Supplemental at 1-2; Thoms Direct at 10-11.

### 2. The Board Should Adopt the Service Quality Standards and Self-Effectuating Penalty Mechanisms Proposed by the Ratepayer Advocate

The Ratepayer Advocate's proposed plan is designed to ensure that Verizon-NJ provides the consistently high quality of service that Verizon-NJ would need to provide in a competitive market place. Alexander Direct at 7-10. The existing service quality standards, combined with additional metrics from the Carrier-to-Carrier Guidelines, represent a good starting point. However, these standards should be improved to reflect developments in the industry (such as technological advances), to capture important areas of customer service and reliability not measured by the current standards and to incent Verizon-NJ to operate as if it were facing competitive service quality pressures. *See* Alexander Direct at 7-10. In fact, in its independent audit of Verizon-NJ, the Liberty Consulting Group recognized this, concluding that comprehensive service quality standards are necessary "[u]ntil competition in the local service market is sufficient to provide the incentives for good service quality." Liberty Audit at 81.

To accomplish these goals, the Ratepayer Advocate proposes a new comprehensive service quality standards plan. Alexander Direct at 3-4, 13-34, Exhs. BA-2, BA-3; Alexander Supplemental at 1-2. The Ratepayer Advocate's proposal would improve upon the current plan and upon Verizon-NJ's proposed plan first by adding standards for certain important activities not currently monitored. Alexander Direct at 21, Exh. BA-3; Alexander Supplemental at 1-2; *see* Selwyn Direct at 44. For example, standards should be added to measure installation timeliness and appointments met, average repair interval for repeat troubles, customer outages, and call center performance. Alexander Direct at 21-23, Exh. BA-3.

Second, the Ratepayer Advocate recommends replacing the current surveillance and exception levels standards for non-compliance with baseline performance standards. Alexander Direct at 24-25. The Board should hold Verizon-NJ to the highest level of performance readily achievable by an incumbent local exchange carrier. Thus, the Ratepayer Advocate's plan calls for these baselines to be established at levels based on the best practices of incumbents in New Jersey or elsewhere. Alexander Direct at 24-25.

Third, under the Ratepayer Advocate's proposal, Verizon-NJ's failure to meet these baselines should trigger self-effectuating penalties, with the level of the penalty based on the severity and duration of the performance failure. Alexander Direct at 25-31.

Finally, the Ratepayer Advocate recommends that the Board establish a code of conduct to govern the interaction of Verizon-NJ with its affiliates. Alexander Direct at 31-34; Selwyn Direct at 81-85. For example, the same policies that the Board has implemented prohibiting bundled product marketing in the electric and natural gas industries should be required so that Verizon-NJ cannot unfairly jointly market with its affiliates. Alexander Direct at 32-34; Selwyn Direct at 81-85.

The third tenet of the Ratepayer Advocate's service quality proposal – a self-effectuating penalty mechanism – is particularly crucial to an alternative regulation plan and is part of such plans in New York, Massachusetts, Rhode Island, Vermont and Maine. T.1421:14-21 (09/07/01); RPA Exh. 45, VNJ-RPA 499. In fact, the Maine Commission recently increased the amount of penalties that Verizon-ME would be required to pay for providing inadequate retail services. Maine Alt Reg Order § E.1. Automatic penalties will create the proper incentives for Verizon-NJ to provide high quality service. Alexander Direct at 7-10, 26-28; *see* Maine Alt Reg

Order § E. Indeed, in presenting a similar self executing penalty plan (which was subsequently adopted by the Board) for Verizon-NJ's provision of wholesale services, the Board's staff expressly recommended the plan because it would "ensure that Verizon[-NJ] provides quality wholesale services," and because it "establishes appropriate financial incentive[s] for Verizon[-NJ]." *I/M/O the Investigation Regarding Local Exchange Competition for Telecommunications Services*, Docket Nos. TX95120631, TX98010010, Board Meeting, T.2:18-19, 7:19-20 (10/12/01).

Automatic penalties will also reduce regulatory delay and costs, a specific New Jersey statutory imperative. N.J.S.A. § 48:2-21.18(a)(4); Alexander Direct at 3, 7-8. Nobody (other than perhaps Verizon-NJ), and least of all New Jersey consumers, benefits from a service quality plan that requires the Board to take affirmative steps to remedy any Verizon-NJ sub-par performance. Rather, self-effectuating penalties provide consumers with timely benefits and conserve the Board's resources for other matters.

Despite these benefits Verizon-NJ opposes the Ratepayer Advocate's service quality plan. RPA Exh. 46, VNJ-RPA 25. Verizon-NJ does so because it realizes the plan will lay bare its service performance shortcomings, and thereby expose it to monetary liability. Phillips Rebuttal at 6, 9, 12, 15-17. While Verizon-NJ claims that it is providing quality service, this claim is belied by statements that it would not be able to meet the performance criteria proposed by the Ratepayer Advocate. *See* Phillips Rebuttal at 6, 9, 12; RPA Exh. 46, VNJ-RPA 492.

Indeed, Verizon-NJ's central objection to the Ratepayer Advocate's plan is the unsupported assertion that raising the bar above current service quality standards by any amount will make the new standards "unattainable." For example, Verizon-NJ opposes the application of

a 94% baseline to the "Percent Service Order Provisioning Completed Within 5 Working Days" metric because such a baseline "would simply penalize Verizon-NJ." Phillips Supplemental at 2. Moreover, Verizon-NJ's own testimony suggests that Verizon-NJ's ability to meet existing service quality metrics is not indicative of its overall performance. Verizon-NJ meets these standards not by overall quality, but by deploying resources to target the existing standards. "The introduction of new and untested metrics would cause Verizon-NJ to divert personnel and resources away from established service quality initiatives and devote them to these new metrics." Phillips Rebuttal at 6. Accordingly, Verizon-NJ has no choice but to oppose any significant expansion of existing service quality standards.

Moreover, to the extent that Verizon-NJ claims that the Ratepayer Advocate's proposal is unattainable, the Ratepayer Advocate notes that, in its independent audit of Verizon-NJ, Liberty Consulting recommends a system of service quality standards that, rather than measure Verizon-NJ's performance after the fact, would monitor leading indicators – a much more meaningful criterion.

> The current reporting to the Board may not provide timely information about service problems because of the lag that exists between significant reductions in capital or workforce resources and the reporting of service quality results that could be affected by those reductions. Until competition in the local service market is sufficient to provide the incentives for good service quality, the Board needs to monitor leading indicators and not have to wait until problems exist before fulfilling its regulatory obligations. Moreover, the suggested reporting should require a minimal effort by [Verizon-NJ] and thus would be a cost-beneficial improvement.

Liberty Audit at 81; *see id* at 37. Liberty Consulting concluded that this significant change in service quality standards would only require "minimal effort" by Verizon-NJ to implement.

Consequently, rather than representing a valid reason for the Board to reject the Ratepayer Advocate's service quality proposal, Verizon-NJ's opposition cries out for its adoption, an action that would truly ensure that New Jersey consumers receive high quality telecommunications services. Phillips Rebuttal at 9.

## IV. RECLASSIFICATION OF MULTI-LINE BUSINESS SERVICES

In its PAR-2 Petition, Verizon-NJ seeks "to reclassify multi-line business services currently designated as Rate Regulated, as Competitive pursuant to N.J.S.A. 48:2-21.19." PAR-2 Petition at 4 ("Petition for Reclassification"). N.J.S.A. 48:2-21.19 requires (1) that the Board develop a list of criteria for competitive classification, and (2) that such list contain, at a minimum, "evidence of ease of market entry; presence of competitors; and the availability of like or substitute services in the relevant geographic area." N.J.S.A. 48:2-21.19(b). As established below, Verizon-NJ's Petition for Reclassification fails to provide the required evidence, and the Board should deny it. More importantly, however, this case provides a unique opportunity for the Board to fulfill its duty under the statute to establish a formal process for the determination of service reclassification.

Verizon-NJ evidently wants the Board's examination of competition under N.J.S.A. 48:2-21.19(b) to be encompassed in the single criterion, "presence of competitors." *See* Shooshan-Weber-Taylor Direct at 19-20. Moreover, Verizon-NJ seeks to carry its burden on that criterion by attempting to demonstrate the mere *possibility* of entry by competitors. These are recurring failures: Verizon-NJ fails to recognize that the three minimum criteria required under N.J.S.A. 48:2-21.19(b), as well as the additional criteria proposed *infra*, are separate and independent requirements designed to lead the Board to a conclusion about the overall state of competition in

given services. Further, Verizon-NJ fails to present the Board with any reliable information on the actual state of competition in New Jersey. A simple head count of those who have received authority to do business in the State of New Jersey, many of whom are failing even as Verizon-NJ counts them, cannot suffice to pass either the tri-partite statutory test of ease of entry, presence of competitors and availability of like or substitute services, or the additional criteria proposed by the Ratepayer Advocate.

The Maine Public Service Commission recognized that when Verizon sought deregulation of a particular service, it must show effective competition with evidence that goes well beyond what Verizon-NJ offers here. According to the Maine Commission:

> At a minimum, Verizon must show that one or more facilities-based CLECs have facilities in place to provide service to customers with ten or more lines, but it must also show that the CLECs are actively marketing and providing their services to such customers. Whether CLECs provide service throughout the entire wire center is another factor we will consider in determining whether competition is effective.

Maine Alt Reg Order at 11; *see also id.* at 26.

Even under Verizon-NJ's relaxed standard, however, the evidence presented in this case does not merit reclassification. Verizon-NJ has presented this Board with questionable data, designed to lead to the erroneous conclusion that competition in multi-line services currently exists in New Jersey. In point of fact, even the few firms that have tariffed multi-line business offerings are rapidly exiting the market. In a prime illustration of the current environment for telecommunications providers in New Jersey, Sprint has recently announced the discontinuation of its business-focused ION services, thus removing one of the "big three" virtually completely from competition with the incumbent in the services that it seeks to have reclassified as

competitive. Shawn Young, "Sprint Plans to Cut 7% of Work Force After Posting 60% Drop in Net Income, " Wall Street Journal, Oct. 18, 2001 (Attachment 1).

Verizon-NJ's own figures demonstrate that even the parts of its business now deemed competitive are not yielding competitive results. The attachments to the testimony of Verizon-NJ witness Edwin F. Hall show that Verizon-NJ's rate of return on supposedly competitive services is nearly **[BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY]** times its rate of return on regulated services. Hall Direct, Exhibits A-5, A-6, A-7. In particular, based on the figures that Mr. Hall provided in conjunction with his testimony, Verizon-NJ's rate of return on regulated services for the year ending September 12, 2000 was **[BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY]**. *Id.*, Exhibit A-5. Using the same methodology and data set used by Mr. Hall to reach this result, Verizon-NJ's rate of return on competitive services for the same period was **[BEGIN VERIZON PROPRIETARY] [END VERIZON PROPRIETARY]**. *Id.*, Exhibit A-6, A-7; *see also,* T..4800:2-4805-14 (12/20/01); Liberty Audit at 32.[23]

It is well understood that a defining characteristic of markets with little competition is the excessive returns earned by dominant firms in those markets. F.M. Scherer & David Ross, *Industrial Market Structure and Economic Performance* at 415-416 (3d ed. 1990). If Verizon-NJ's own numbers are to be believed, Verizon-NJ's staggering rate of return in markets now

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[23] Mr. Hall calculated the return for regulated services by dividing the "Earnings" shown in column E (Intrastate Rate Regulated) of his Exhibit A-6 by the "Rate Base" shown in column E (Intrastate Rate Regulated) of his Exhibit A-7. *Compare* Hall Direct, Exhibit E-5 *with* Hall Direct, Exhibits E-6, E-7. The Ratepayer Advocate calculated the return for competitive services by dividing the "Earnings" shown in column D (Intrastate Competitive) of Mr. Hall's Exhibit A-6 by the "Rate Base" shown in column D (Intrastate Competitive) of Mr. Hall's Exhibit A-7.

deemed competitive demonstrates that even that supposed competition is a mirage. This suggests that the Board should proceed with great caution before it reclassifies services in the hope that competition will yield benefits for consumers. So far, apparently, the principal beneficiary of Verizon-NJ's participation in markets deemed competitive has not been consumers, but Verizon-NJ itself. [24]

The Board should recognize that the development of competition has been nipped in the bud by both the current economic climate and the anti-competitive wholesale practices of Verizon-NJ. The time is not ripe for reclassification of multi-line business services and the evidence presented by Verizon-NJ, properly understood, fails to support such a step.

The time is ripe, however, for the Board to comply with the mandate of the Legislature by the formal promulgation of standards for service reclassification. The minimum criteria specified in N.J.S.A. 48:2-21.19(b) are an important starting point for the analysis of competition in specific services that the Legislature envisioned. It is obvious, however, from the self-serving interpretation that Verizon-NJ has given them that the Board must elaborate on these criteria to implement the will of the Legislature. Indeed, the Legislature itself recognized this when it required the Board to develop standards under N.J.S.A. 48:2-21.19(b), clearly indicating that the statutory standards were only a starting point. This case provides a perfect opportunity for the Board to fulfill its duty and establish a formal proceeding to address the requirements for reclassification of services. The Ratepayer Advocate respectfully recommends that the Board, in

[24] An alternative possibility is that these results are the product of Verizon-NJ's manipulation of its accounts to show a low return on regulated services. If this is the case, the numbers, or at least the way they were created, call into question Verizon-NJ's showing on other issues important to this proceeding, including the question of a subsidy for basic residential exchange services and the proper determination of Verizon-NJ's return on equity. Indeed, if these results are the product of manipulation, they provide an explanation for Verizon-NJ's ability to escape any earnings sharing obligation during PAR-1.

carrying out its statutory duty, focus on examining competition (rather than competitors), the impact that reclassification may have upon competition in a given service, and the existence of effective regulatory controls over Verizon-NJ's imposition of entry barriers and discrimination against retail competitors. Thus, to more thoroughly examine the state of competition in services proposed for reclassification, and to provide regulated entities with more clarity about their evidentiary burden, the Board should consider the standards proposed by the Ratepayer Advocate in Section IV.C., *infra*, in addition to those set out in N.J.S.A. 48:2-21.19(b).

### A. Serious Deficiencies in Verizon-NJ's Showing Preclude Consideration of Reclassification

Before the Board begins any examination of specific services for reclassification under N.J.S.A. 48:2-21.19, it should ensure that Verizon-NJ's application presents information necessary for a proper determination of the general state of competition in the relevant services. Verizon-NJ's current application fails to do so. Specifically, the Ratepayer Advocate submits that the Board should not consider reclassification unless and until Verizon-NJ presents cost and revenue information on the services that it seeks to reclassify as competitive. In addition, the Board should require that Verizon-NJ present more than an arbitrary line of demarcation between monopoly and competitive services. Finally, due to Verizon-NJ's monopoly hold of the local network facilities and its historic tendency to delay and obstruct the provisioning of competitive retail services, the Board should require a specific showing of actual (not theoretical) competition in each of the services proposed. A level playing field is a prerequisite to the development of effective and lasting competition, and thus, a prerequisite to reclassification of services.

### 1. Absent A Cost Of Service Analysis On The Services Proposed For Reclassification, Parties Cannot Determine Whether, Even Now, Verizon-NJ Is Providing Those Services At Competitive Prices

As discussed above, Verizon-NJ's *residential* service revenues significantly exceed those services' costs. *See supra* Section III.C. It is likely that the same situation exists with regard to the multi-line *business* services at issue here. The existence of such high margins is an indicator of the existence and exercise of market power by Verizon-NJ and must be examined as part of any claim for reclassification. Despite the obvious connection between such data and a showing of competition, Verizon-NJ has not provided cost/revenue data on the multi-line business services that it seeks to have reclassified. RPA Exh. 57, RPA-VNJ 293.

The Ratepayer Advocate requested that the Board order Verizon-NJ to prepare a cost of service study for reclassification as part of its letter motion dated February 26, 2001. Because Verizon-NJ's Petition did not propose any explicit rate revisions, however, the Board denied this request. June 20 Order at 3-4. The Audit of Verizon-NJ recently conducted by Liberty also fails to include such information, although many participants were hopeful that it would. Indeed, Senator Cody, speaking on behalf of the New Jersey Senate Democrats, has stated that the "...goal in calling for an audit was to show Verizon's revenue derived from basic exchange service, the amount invested in the New Jersey telecommunications network and the amount of profits returned to stockholders...." "Codey on Verizon: Democrats Still Want Full Audit," News From The Senate Democrats, GOVERNMENT NEWS NETWORK, December 20, 2000.

The lack of cost of service information on Verizon-NJ's multi-line business services significantly impedes the Ratepayer Advocate's and other parties' abilities to assess Verizon-NJ's current and future market power in the services for which it requests reclassification. More

importantly, the absence of such information precludes a showing of compliance with the requirements of N.J.S.A. 48:2-21.19(b) by Verizon-NJ. The actual or potential exercise of market power by Verizon-NJ in these services is the crux of the reclassification issue. A cost of service analysis is one of the most effective ways to investigate Verizon-NJ's current market power in the services at issue. Without a definitive analysis of Verizon-NJ's actual market power, through the use of a cost of service study, Verizon-NJ itself cannot show that it is without the ability to sustain increased prices in these services. Absent that showing, New Jersey ratepayers are potentially at the mercy of Verizon-NJ when it comes to rates for the relevant services. Therefore, absent information on the cost of service of multi-line business services, Verizon-NJ's Petition should not be considered by the Board. *See* Selwyn Direct at 87.

#### 2. "More Than One Line" Is Not The Proper Line Of Demarcation Between Monopoly And Competitive Services

The services for which Verizon-NJ seeks reclassification include four general categories of service: switched local services, switch-related ancillary services, private line services, and other ancillary services. *Id.* at 6. While Verizon-NJ failed to define "multi-line" in its original filing, subsequent discovery revealed that Verizon-NJ considers multi-line business services to include any business to which Verizon-NJ provides two or more voice-grade lines of service. RPA Exhs. 13, 57, RPA-VNJ 170, 176, 177, 208.

This line of demarcation is improper because reclassification of multi-line business services as defined by Verizon-NJ will effectively result in the reclassification of all business services. Upon reclassification, Verizon-NJ would be able to manipulate the standard to include single-line businesses as well. As admitted by Verizon-NJ, having won reclassification of all business

services of two or more lines, Verizon-NJ would be in a position to offer all single-line businesses a second line at no charge. The Rate Regulated single-line customer would then instantly be converted into a Competitive multi-line customer, more susceptible to an exercise of market power by Verizon-NJ. T.270:17-272:14 (8/2/01). The Board should not permit Verizon-NJ to manipulate the regulatory process so that all business services are effectively reclassified.

#### 3. Verizon-NJ Should Be Required To Provide Additional Evidence As To The Practical Availability Of Competitive Alternatives To Its Multi-Line Business Services Beyond The Theoretical Existence Of Competitor Offerings

In assessing the competitive nature of the various services proposed for reclassification by Verizon-NJ, the Board must be certain that it examines actual competition in those services, and not merely their theoretical availability from firms that are at most would-be "competitors." Media covering the communications industry continually report on the delay and technical problems faced by individuals and businesses that seek to obtain service from would-be competitors of Verizon-NJ. Competitors, and wholesale service quality measures, report that the root of the problem is in the provision of underlying facilities to competitors by Verizon-NJ, the direct retail competitor of CLECs for both individual and business customers. *See, e.g.*, William Glanz, "Phone Act Puts Consumers on Hold," The Washington Times (February 8, 2001) (Attachment 1); Section IV.C.1.a. Dr. Selwyn experienced the frustration of the small business owner due to Verizon's control of bottleneck facilities in attempting to obtain service from AT&T for his new offices in Boston, Massachusetts. Selwyn Supplemental Direct at 5-6. Dr. Selwyn is an experienced and sophisticated telecommunications consultant; it is not difficult to imagine that

the frustration of a neophyte businessman, without knowledge of the complexities of the telecommunications industry, would be much greater.

The frustration caused customers by these anti-competitive acts are costly and irreversible for competitors attempting to establish themselves against the incumbent. If these acts are allowed to continue unchecked, the development of competition in local service is an impossibility. To ensure that competition is actually reaching the customers that it is designed to benefit, and that competitors have a realistic opportunity to survive in the local market, the Board should not consider any request for reclassification until Verizon-NJ is able to "demonstrate that end user customers …perceive the service provisioning process as essentially the same regardless of whether Verizon or a CLEC is the customer's retail service provider." Selwyn Supplemental Direct at 10. The Ratepayer Advocate respectfully recommends that the Board institute a customer survey to periodically assess the evolving state of competition (as New Jersey consumers perceive it). This recommendation is further described in Section IV.C.1., *infra.*

**B. Verizon-NJ's Request Should be Denied**

Should the Board decide to consider Verizon-NJ's Petition despite the shortcomings described above, the Petition should nevertheless be denied for the following reasons: (1) Verizon-NJ's faulty survey data cannot be considered "evidence" in the common understanding of the word, or as intended by N.J.S.A. 48:2-21.19(b); (2) Verizon-NJ fails to support its contention that it does not hold market power in the services for which it seeks reclassification; and (3) Verizon-NJ fails to meet the minimum criteria set out in N.J.S.A. 48:2-21.19(b).

### 1. Verizon-NJ Relies On Faulty Survey Data In Attempting To Establish The Presence Of Competition

Verizon-NJ relies upon two general categories of support for its claim that multi-line business services in New Jersey should be reclassified as Competitive. First, Verizon-NJ presents the Board with *selective* data on the number of lines lost, the number of competitor collocation arrangements, and E911 lines purporting to show that a variety of firms currently serve as true competitors in the provision of multi-line business services. Second, Verizon-NJ presents survey data, gathered and analyzed by Mr. Shooshan and his associates, regarding customer views of the availability of competitive business services in New Jersey. Shooshan-Weber-Taylor Direct at 40-41.

As explained below, the Ratepayer Advocate submits that both the selective data and the business customer survey are flawed in their development and presentation, and should not be properly considered "evidence" in favor of reclassification, as required under N.J.S.A. 48:2-21.19(b) for the following reasons. First, the line loss data presented by Verizon-NJ presents an inaccurate picture of the state of competition in New Jersey. Two other state public utilities commissions have rejected the use of such data to establish the extent of competition in a given region. *See Petition of Qwest Corporation for Competitive Classification of Business Service in Specified Wire Centers*, Seventh Supplemental Order, Docket No. UT-000883 (December 2000) ("Washington Order"); *Investigation into Specified Competitive Tariffs to Determine Proper Classification of the Tariffs and to Determine Whether Refunds are Appropriate*, Hearing Examiner's Proposed Order, Docket No. 98-0860 (March 30, 2001) ("Illinois Order").

Second, Verizon-NJ improperly counts collocation arrangements, including in its figures abandoned collocation space to attempt to establish the presence of competitors in New Jersey. T.146:8 (7/30/01). Given the state of the telecommunications industry in New Jersey and throughout the nation, the inclusion of abandoned collocation arrangements makes the collocation data submitted by Verizon-NJ useless or worse, misleading. Third, rather than submit information on E911 lines developed by the competitors providing those lines, Verizon-NJ chose to submit its own data, subsequently shown to be inflated. Finally, in its customer survey, Verizon-NJ failed to ask respondents why, given the competition alleged, they chose to remain customers of Verizon-NJ. In so doing, Verizon-NJ implicitly recognizes that its own market power may be the answer. For these reasons, the Board should deny Verizon-NJ's Petition as unsupported by reliable evidence.

#### a. Verizon-NJ Improperly Relies On Line Loss Instead Of Actual Customer Loss To Establish That Competition Exists

Verizon-NJ claims that "[b]etween 1997 and 2001, Verizon experienced substantial losses from its General Business Line of Business," amounting to some **[BEGIN VERIZON-NJ PROPRIETARY]** **[END VERIZON-NJ PROPRIETARY]** allegedly lost to competitors. Shooshan-Weber-Taylor Direct at 55. Dr. Selwyn has pointed out that these figures amount to only 4% of the total business lines in New Jersey. Selwyn Direct at 109. However, even that low figure may be exaggerated and it is important that the Board not be confused by this line loss information. Line loss does not necessarily equate to customer loss. As pointed out by Commissioner Butler at hearing, "[n]o matter how the data is …organized, if there's 12 lines and a customer leaves, then that's counted as 12 line losses[.]" T.63:20-23 (7/30/01).

While a study of customer loss would have given more accurate account of the state of competition in multi-line business services, Verizon-NJ claimed in discovery that it "does not track and maintain historical counts of business 'customers.'" AT&T Exh. 15, AT&T-VNJ 238. Instead, Verizon-NJ obtained an unreliable estimate of "customer loss" through a compilation of Billing Telephone Numbers ("BTNs"). Unfortunately, BTNs count each billing address as an individual customer, and may significantly overstate the true number of customers lost. AT&T Exh. 15, AT&T-VNJ 1(a); T.394:6-404:25 (8/2/01). Indeed, both the Washington Utilities and Transportation Commission and the Illinois Commerce Commission have indicated that line loss data is unreliable without accompanying information on the number of customers lost. Washington Order at ¶68; Illinois Order § III.E.5.a.(4).[25] In each case, the study criticized was presented by Verizon-NJ Witness Shooshan. The Washington Commission stated, "Qwest relies on the percentage of *lines* being served by competitors as evidence of effective competition. However, this data does not reveal how *many* customers purchase those lines." Washington Order at ¶68. This Board should likewise recognize Verizon-NJ's line loss data as unreliable without accompanying information on customer loss.

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[25] The proceeding from which the Illinois Order originated was dismissed as a result of Public Act 92-0022, which was passed by the Illinois Legislature in July 2001. The legislation does not, however, address the issue of line loss versus customer loss and does not alter the fact that the Illinois Commerce Commission finds line loss information alone to be an inaccurate measure of competition.

### b. Collocation Is An Improper Basis Upon Which To Demonstrate Competition

Verizon-NJ claims that, due to the number of collocation arrangements provided to competitors in New Jersey, those competitors have the ability to serve some 98% of the business line markets in New Jersey. Shooshan-Weber-Taylor Direct at 51-52. One would expect that this ability, coupled with pro-competitive regulation of the telecommunications industry, would allow competitors to capture a significant share of the business line market in New Jersey. However, as Dr. Selwyn points out, competitors have captured only a very small share of that market. Selwyn Direct at 109. Moreover, Verizon-NJ cannot tell the Board how many multi-line business services are provided by means of these collocation arrangements because, as Verizon-NJ freely admits, it "does not track the information[.]" RPA Exh. 13, RPA-VNJ 329. The relatively small market share enjoyed by competitors demonstrates, as well as any of the data submitted by competitors in this proceeding, two simple facts: (1) that competition is not yet a reality for multi-line business customers in New Jersey, and (2) that more than mere collocation is necessary to permit competitors to compete effectively with Verizon-NJ. Verizon-NJ's count of collocation arrangements in New Jersey is therefore meaningless.

Moreover, Verizon-NJ's measures of collocation as a surrogate for competitive service are inherently inaccurate. Verizon-NJ admitted at hearing that abandoned collocation arrangements are included in the collocation data it presented. T.146:8 (7/30/01). Verizon-NJ is able to break out the collocation arrangements left by the four data CLECs that are no longer operating, resulting in a significantly decreased coverage area. T.146:8-12 (7/30/01). However, it fails to account for collocation arrangements abandoned or left unused by competitive voice

providers. As a result, collocation becomes an inherently unreliable measure of actual competitive service and should not be considered by the Board.

### c. Verizon-NJ Improperly Relies On Inflated Estimates Of CLEC E911 Lines

Verizon-NJ observed at the hearing that "counting access lines is sometimes ambiguous[.]" T.388:7 (8/2/01). Nevertheless, when faced with a choice between its own data on competitors' lines and the similar data provided by competitors, Verizon-NJ improperly chose its own inflated estimates, thus misrepresenting the actual number of E911 lines pertaining to competitors.

Specifically, Verizon-NJ claims that its "E 911 listings data show that CLECs were serving at least 220,500 voice lines with their own facilities or with UNE-Ps by January 17, 2001." Shooshan-Weber-Taylor Direct at 45. That figure includes 211,000 E911 business access lines reported as pertaining to the two largest competitors in New Jersey. However, the same data, as provided by the competitors themselves, shows the total of E911 listings to be approximately **[BEGIN AT&T/MCI PROPRIETARY] [END AT&T/MCI PROPRIETARY]**. AT&T Exhs. 13, SR-AT&T 1; AT&T Exh. 14, SR-MCI 1. Verizon-NJ was not able to explain the discrepancy. T.390:13-25 (8/2/01).

Moreover, while Verizon-NJ claims that the total number of E911 lines belonging to competitors may be understated due to a single E911 identifier for an entire PBX trunk, it fails to acknowledge that the opposite may be true. Where a single PBX trunk serves multiple stations configured for identified outward dialing, the actual number of lines will be overstated by the

E911 data. Selwyn Direct at 103. The Board should recognize the Verizon-NJ figures as self-serving and completely unreliable as an indicator of competition in business access lines.

#### d. Verizon-NJ's Survey Failed To Ask Essential Questions About The Actual State Of Competition

Another of the crumbling pillars upon which Verizon-NJ rests its claim of competition in multi-line business services is a survey of small, medium and large business customers on the availability and marketing of like services by competitors. Shooshan-Weber-Taylor Direct at 63-70. Rather than conducting research on the actual state of competition by asking, for example, how many of those surveyed actually obtain service from competitors, the survey purports to measure competition indirectly through business perceptions of availability and marketing. Evidently, Verizon-NJ failed to include more direct questions in the survey itself because of the likelihood of results unfavorable to it in this proceeding. Selwyn Direct at 112.

Specifically, Verizon-NJ failed to ask *on the record* (1) whether businesses were actively receiving service from competitors, and (2) for those customers remaining with Verizon-NJ, why they had not switched to competitive offerings. Notably, however, Verizon-NJ witness Shooshan indicated that he had *off the record* "probed pretty deeply into how the decision was being made and what attributes were attractive to them and what attributes were attractive to the incumbent." T.157:4-7 (7/30/01). While this information would have provided the Board with market-based information on the actual state of competition in multi-line business services in New Jersey, Verizon-NJ chose to keep the information to itself. Presumably, had the information obtained been favorable to Verizon-NJ, it would have been submitted in some form.

Due to the slanted nature of the questions presented in the customer survey, the Board should disregard it as evidence of the actual state of competition. As the Ratepayer Advocate's witness observed:

> [t]he survey results simply offer anecdotal evidence that serves to support VNJ's contention that there are competitors present in the market. Moreover, the responses provide very little insight as to the presence of competition as it exists today[.]

Selwyn Direct at 112. The Board should require concrete data demonstrating the existence of actual competition in the relevant services for each market affected. Indeed, the Ratepayer Advocate respectfully recommends that the Board implement its own program for monitoring the evolving state of competition in New Jersey through the use of customer surveys, explicitly contemplated by the Board in its 1993 Order establishing PAR-1. 1993 Order at 133.

### 2. Verizon-NJ Fails to Demonstrate the Absence of Market Power With Respect to All Customers

#### a. Verizon-NJ Improperly Excludes Market Share From its Analysis

Verizon-NJ expends much energy and ink attempting to explain why this Board should pay no attention to its large market share in the services for which it seeks reclassification. For example, Verizon-NJ witness Taylor stated during the hearing:

> I don't think there's any dispute that if you have a large market share, a small change in your price has a bigger effect on market price than if you have a small share of the market.

T.209:9-13 (7/30/01). In addition, Verizon-NJ attempts to demonstrate that AT&T witnesses, and the economic community in general, find market share to be an unreliable indicator of market power. *See, e.g.*, Shooshan-Weber-Taylor Rebuttal at 13-16. The Board will not fail to notice,

however, that each passage cited points *only* to the fact that market share must be examined alongside other indicators for a true picture of competition to emerge.[26]

In addition, despite its oft-repeated contention that "market share and related tests are inappropriate for reclassification decisions," Shooshan-Weber-Taylor Rebuttal at 13, Verizon-NJ relies heavily on the Department of Justice/Federal Trade Commission Merger Guidelines in defining market participants.[27] Shooshan-Weber-Taylor Direct at 24. The Merger Guidelines, however, specifically require a market share analysis as follows:

> [t]he Agency will normally calculate market shares for all firms (or plants) identified as market participants in Section 1.3 [the section relied upon by Verizon-NJ] based on the total sales or capacity currently devoted to the relevant market together with that which likely would be devoted to the relevant market in response to a 'small but significant and nontransitory' price increase.

Merger Guidelines at 32. Verizon-NJ should not be able to pick and choose in this manner. As even its own witness concedes, market share is relevant to market power. T.209:9-13 (7/30/01).

The Board should not be misled by Verizon-NJ's attempts to deflect the focus of this proceeding from the actual state of competition in multi-line business services to arguments on the possibility of competition based upon semantic interpretations of the statute and self-serving conjecture as to the ability of competitors to enter the market. Any reclassification inquiry must include an examination of market share, as Verizon-NJ itself implicitly recognized.

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[26] Thus, Verizon-NJ variously quotes AT&T as stating, "…market share alone is not a valid measure of market power[,]" "…market share is one of the economic determinants of market power[,]" and "…it is especially important to take excess capacity into account in assessing … market power." Shooshan-Weber-Taylor Rebuttal at 13-15.

[27] Verizon-NJ Witness Taylor indicated at hearing that one of the elements of market power is market share. T.207:22 (7/30/01). In addition, Verizon-NJ Witness Taylor repeatedly referred to the Department of Justice's examination of market concentration using the Herfindahl-Hirschman Index ("HHI"), a measure that is based entirely upon calculations involving individual market share. *See*, *e.g.*, T.135:3-13 (7/30/01).

**b. Verizon-NJ Fails To Demonstrate The Absence Of Market Power, Even As Verizon-NJ Defines It**

While eschewing the Merger Guidelines' recommended examination of market share, Verizon-NJ paraphrases the definition of market power put forth in those Guidelines: "[t]he ability to hold price profitably above its competitive level by restraining output." T.206:25-207:1 (7/30/01); *see* Merger Guidelines at 9. The essential inquiry in an investigation of market power, says Verizon-NJ, centers on "the supply and demand elasticities that the firm faces." T.207:17-18 (7/30/01).[28]

Despite this clear recognition of the proper test for market power, *Verizon-NJ conducted no studies of demand or supply elasticity in preparation for this proceeding*. T.210: 2-25 (7/30/01); RPA Exhs. 11, 57, RPA-VJN 194, 195. That Verizon-NJ would seek reclassification of multi-line business services without providing evidence of market share or other recognized determinants of market power is completely inadequate. The Board cannot allow theory and conjecture to substitute for the "evidence" required by N.J.S.A. 48:2-21.19(b).

**c. If Verizon-NJ's Request Is Granted, Verizon-NJ Will Be Able To Circumvent Regulation Of Business Services Completely**

Beyond the fact that Verizon-NJ has failed to present "evidence" as required by statute, there are policy reasons for denying Verizon-NJ's request for reclassification. Among these is the prospect that after reclassification Verizon-NJ will be in a position to unilaterally remove all

[28] Demand and supply elasticities measure the reactions of consumers and producers to a sustained increase in the price of a service. Faced with a sufficiently large price increase, consumers will purchase the service from alternative sources (demand elasticity), while producers will increase the provision of the service at competitive prices in order to capture those consumers that are searching for a new supplier (supply elasticity). Both demand and supply elasticity are measured on a scale between zero and one. The closer demand elasticity is to one, the more likely are consumers to switch providers in response to a price increase; the closer that supply elasticity is to one, the more likely are producers to expand output in response to a price increase.

business services from the scrutiny of the Board. Verizon-NJ Witness Taylor indicated under cross examination that after reclassification it would be possible for Verizon-NJ to offer a promotional second line to single line customers at no charge and thereby convert the single-line Rate Regulated service in to a multi-line Competitive service, not subject to the oversight of the Board. Tr. 270:17-272:14 (8/2/01). In order to prevent this situation from occurring, the Board should deny Verizon-NJ's Petition on any or all of the deficiencies identified herein.

### 3. Verizon-NJ Fails To Meet The Statutory Criteria

A number of the problems with Verizon-NJ's presentation of data are described above, and they alone should lead the Board to dismiss Verizon-NJ's Petition. However, even accepting the flawed data presented by Verizon-NJ, it has not met its statutory burden for reclassification of multi-line business services. Specifically, a smattering of ailing competitors does not satisfy the "presence" standard under N.J.S.A. 48:2-21.19(b), the absence of effective competition precludes a showing of like or substitute services, and substantial barriers to entry continue to prevent competitors from entering the market.

#### a. Verizon-NJ Does Not Demonstrate the Presence of Competitors

The presence of competitors is a simple standard that should hardly cause difficulties in interpretation. A competitor is present if it is offering the same or substitute services in the same geographic areas as the incumbent. Thus, in order to demonstrate the presence of competitors under N.J.S.A. 48:2-21.19(b), Verizon-NJ must demonstrate that (1) competitive telecommunications providers are present in the relevant geographic areas, and that (2) they are providing the same or substitute services as Verizon-NJ offers to multi-line business customers.

To demonstrate the presence of competition, Verizon-NJ must provide the Board with more than "head count" data and conjecture about possible market presence. The Ratepayer Advocate submits that the language of the statute requires an affirmative showing of the actual presence of true competitors in the markets in question. Verizon-NJ's suppositions about the potential that existing or hypothetical firms might offer such services will not reach the mark.

First, Verizon-NJ contradicts itself in defining the "presence of competitors" criterion. Specifically, Verizon-NJ attempts to impermissibly broaden the requirements of the statute with the proposition that

> [c]ompetitors are present in a market if they have existing customer relationships that permit them to diversify from a related product or adjacent geographic market into the market in question—*e.g.*, long distance carriers that (*collectively*) have established business relationships with virtually every business customer should be considered present in the local exchange services market if they can rapidly provide local services.

Shooshan-Weber-Taylor Direct at 23 (emphasis added). According to Verizon-NJ, therefore, competitors can be "present" in a market even when they have yet to begin offering the product in question or operating in the relevant geographic area. This is clearly a twisted interpretation of the statutory requirement, as recognized by Verizon-NJ Witness Taylor when he stated at hearing, "I am not a lawyer, but the word 'presence' to me means existence." T.340:13-14 (8/2/01).

Second, even the small number of competitors that Verizon-NJ attempts to identify are fading from the market. Four major DSL competitors have declared bankruptcy since Verizon-NJ's initial testimony was filed.[29] *See* Andrew Backover, "As Dot-coms and Telecoms Crash, the

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[29] Verizon-NJ claims that "[t]he DSL providers are important because: (1) DSL services are substitutes for the switched data services Verizon seeks to have reclassified—Switched 56, ISDN BRI, and ISDN PRI; (2) DSL providers can use DSL transmission paths to provide voice services; and (3) … collocators providing DSL service can easily expand into voice service." Shooshan-Weber-Taylor Direct at 43.

Fallout Lands on Main Street," USA TODAY, June 25, 2001, at B.01; Dinah Wisenberg Brin, "Covad Bankruptcy Latest in Series for DSL Wholesalers," DOW JONES NEWS SERVICE, Aug. 7, 2001. Attachment 1. In addition, WinStar, a national provider of fixed wireless services and owner of two switches in New Jersey, has also removed itself from the market. Selwyn Direct at 100. Finally, Verizon-NJ devotes two pages of its direct testimony to Sprint's ION service, touted as

> digital subscriber line technology to provide local-to-long-distance data and voice services via CLEC or ILEC local loops and via wireless or cable TV.

Shooshan-Weber-Taylor Direct at 64. On October 18, 2001, Sprint announced plans to *permanently discontinue* its ION services, effectively removing itself from competition (in all but Verizon-NJ's theoretical sense) with Verizon-NJ. Shawn Young, "Sprint Plans to Cut 7% of Work Force After Posting 60% Drop in Net Income," WALL STREET JOURNAL, Tech Center (October 18, 2001) (Attachment 1). Perhaps more importantly, the near term outlook for telecommunications providers is bleak indeed, as funding has all but disappeared. Selwyn Direct at 101.

The Board will undoubtedly recognize Verizon-NJ's improper attempt to broaden the language of the statute. And while Verizon-NJ attempts to paint a picture of a future ripe with competitive possibilities, the simple facts belie its claim. Competition in multi-line business services has not yet developed in New Jersey and it cannot be said to be increasing for the foreseeable future.

#### b. Where Competition Does Not Exist, There Can Be No Showing Of Like Or Substitute Services Under Statute

N.J.S.A. 48:2-21.19(b) requires that for each of the services that Verizon-NJ requests reclassified as competitive it make a separate showing that like or substitute services are actually available to consumers in the relevant markets. As in the case of the presence of competitors, it is not sufficient for Verizon-NJ to present generalized data regarding the number of CLECs in New Jersey and extrapolate from that information an inference that the prescribed services are actually available to New Jersey ratepayers. Indeed, Dr. Selwyn's experience in attempting to obtain T-1 service through AT&T in Massachusetts demonstrates quite well one simple fact: while a few firms may advertise like or substitute services, a number of factors, including Verizon's wholesale provisioning of those services, affect actual availability from the point of view of the consumer. *See* Selwyn Supplemental Direct. Therefore, the availability of like or substitute service is a separate and distinct showing required under N.J.S.A. 48:2-21.19(b), that cannot be fulfilled by conclusively stating, "[i]n short, much of the same evidence that shows the presence of competitors shows that like or substitute services are available." Shooshan-Weber-Taylor Panel Direct at 31.

Verizon-NJ cannot make the required showing due to the simple fact that like or substitute services are not currently available to New Jersey ratepayers. As with the presence of competitors requirement, Verizon-NJ improperly attempts to broaden the scope of the relevant inquiry: "competitive like or substitute services … are available *or can be made available in a short time* in virtually every area served by Verizon-NJ." Shooshan-Weber-Taylor Direct at 37. Even Verizon-NJ recognizes that like or substitute services are not available in the relevant geographic areas. This was confirmed in the recently concluded proceeding assessing Verizon-NJ's petition for section 271 authority. In that proceeding, the Ratepayer Advocate showed that

Verizon-NJ's claims of geographically-distributed facilities-based competition were false and that a majority of the state remains subject to exercises of monopoly power by Verizon-NJ. 271 Proceeding, Ratepayer Advocate Initial Brief at 35-37. Moreover, the high market penetration rates retained by Verizon-NJ indicate that business customers do not consider existing CLEC services to be "like or substitute." Selwyn Direct at 116-117. Again, the Board should deny Verizon-NJ's Petition for Reclassification.

#### c. Substantial Entry Barriers Continue To Exist

Ease of entry refers to the ease with which a competitor can enter a market. However, entry as a theoretical matter is not enough. Instead, entry should be " timely, likely and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern." Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, 1992 FTC Lexis 176 (April 2, 1992) ("DOJ Merger Guidelines"). A condition for this is minimal fixed up-front (or sunk) costs, delays, and other economic or legal barriers to entry. Selwyn Direct at 120. Such entry is "easy" if it "would be timely, likely, and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern." DOJ Merger Guidelines at 56.

In this case, Verizon-NJ presents anecdotal evidence that some "competitors" for multi-line business services exist in some regions of New Jersey, and then asserts that this proves that entry barriers do not exist. This is a clear *non sequitur*. As stated by Dr. Selwyn, "the presence of some competitors in key New Jersey markets does not confirm that competition is flourishing in New Jersey or that competitors are not continuing to confront formidable barriers to entry." Selwyn Direct at 127. And the minimal level of competition demonstrated in the relevant services

does nothing to protect New Jersey ratepayers from an exercise of market power by Verizon-NJ. *See* T.438:1-446:8 (8/2/01).

Entry barriers pertaining to multi-line business services include, among other things, UNE rates that are unproven, lack of competitor access to Verizon-NJ OSS systems, customer inertia in switching local providers, and Verizon-NJ price leadership at the retail level. Selwyn Direct at 122-126. As a direct result of these and other barriers to entry, the market for multi-line business services requires substantial resource expenditures by potential competitors.[30] The reality of the situation, however, is that

> [d]espite nominal entry by a few firms in a few key markets, the utter lack of effective competition throughout the state demonstrates that considerable market barriers remain and have worked to limit the ability of competitors to attract market share.

*Id.* at 121.

#### d. Any Determination Of The Existence Of Competition Must Look To Individual Wire Centers, Rather Than Statewide

Verizon-NJ asserts that, because it seeks relief on a statewide level, the relevant geographic area for study under N.J.S.A. 48:2-21.19(b) is the entire State of New Jersey. This is something of a paradox, given that the services proposed for reclassification are local exchange services, served out of individual wire centers throughout the state. This fact is important for, as Dr. Selwyn points out,

> the presence of 'competition' in one community does nothing to protect consumers in a different community in which no alternative provider is presently offering service.

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[30] The Merger Guidelines refer to such markets as "committed," and advise that potential entrants should not be considered in assessing the presence or absence of competition. Merger Guidelines at 27.

Selwyn Direct at 96-97. The Maine Public Service Commission has also adopted this approach, requiring that to achieve deregulation Verizon must show that CLECs are providing service not only within wire centers, but "throughout the entire wire center." Maine Alt Reg Order at 11.

Verizon-NJ's broad-brush approach is yet another instance of its attempt to mask the dismal reality of local competition by improperly altering the scope of the inquiry. Unfortunately for Verizon-NJ, the services under examination, not the coverage of the incumbent, decide the proper geographic scope of the proceeding. Accordingly, "[i]t is insufficient to simply demonstrate that most of the wire centers have a CLEC collocated there, or that at least one line is served via resale or some form of facilities-based competition." Selwyn Direct at 97-98. The appropriate metric, as demonstrated in the testimony of Dr. Selwyn, is the individual wire center from which service originates. If Verizon-NJ cannot demonstrate that competition exists in each wire center throughout the state, it should not be entitled to reclassification. Otherwise, underserved ratepayers throughout New Jersey may be held hostage to an exercise of market power in the form of the unilateral rate determinations of Verizon-NJ.

### C. The Board Should Augment the Minimum Criteria Established by N.J.S.A. 48:2-21.19(b)

When the New Jersey Legislature provided for the reclassification of regulated telecommunications services, it recognized its own limited specialized knowledge of a complex industry. The Legislature decreed that, *at a minimum*, three criteria would be considered in any petition for reclassification of service, those being "evidence of ease of market entry; presence of competitors; and the availability of like or substitute services in the relevant geographic area." N.J.S.A. 48:2-21.19(b). Recognizing the Board's paramount expertise in the field of intrastate

telecommunications, the Legislature required the Board to develop a set of criteria by which to determine the competitive nature of specific services: "the board *shall* develop standards of competitive service[.]" N.J.S.A. 48:2-21.19(b) (emphasis added). The Legislature thus intended that the Board would consciously address the issue of when a service becomes so competitive as to deserve deregulation. The Board has not yet developed criteria for reclassification as required by the Legislature.

Fortunately for New Jersey ratepayers, this case provides an excellent opportunity for the Board to fulfill its duty under N.J.S.A. 48:2-21.19(b) and develop a comprehensive list of criteria to determine when a service is competitive. As the statutory representative of New Jersey's ratepayers, the Ratepayer Advocate recommends that the Board use this opportunity to open a formal proceeding to establish such criteria. Moreover, the Ratepayer Advocate respectfully proposes that the Board begin with the addition of the following criteria: (1) the presence of effective competition, including the ability of competitors to offer services at competitive prices, terms and conditions; (2) a requirement that UNE rates be set at levels that reflect economic cost; (3) compliance with the section 271 competitive checklist; (4) the existence of a requirement for service-by-service reclassification; (5) the absence of an adverse effect on other services; (6) the availability of prompt and effective dispute resolution for competitors (including formal procedures proposed and mandated by the Board); and (7) the existence of "air tight" service quality measures with attendant penalties for noncompliance. Selwyn Direct at 128-135.

These criteria will enable the Board to focus upon the existence of effective competition, rather than the mere arguable presence of competitors, a criterion that is easily manipulated by the incumbent. Moreover, the additional criteria promote an examination of competition on a

service-by-service basis, rather than at the faulty market-wide level that Verizon-NJ proposes in this case. They also require that Verizon-NJ demonstrate that mechanisms are in place to permit entry by new competitors and the absence of discrimination against those competitors by Verizon-NJ. Finally, under these criteria the Board should assess competition at the level of each individual wire center, emphasizing that competition in one area does not mean competition in all.

### 1. The Board Should Require the Presence of Effective Competition

The Board should first explicitly recognize that the mere presence of competitors does not equate with the presence of effective competition. Selwyn Direct at 115. The presence of competitors inaccurately measures the competition Verizon-NJ faces in a given service. A more helpful criterion would be a direct measure of competition, including market share, in a given market, as proposed here by the Ratepayer Advocate. This additional criterion would allow the Board to weigh

> proof that price-constraining competition for the services in question exists prior to granting competitive status, in order to protect consumers from anti-competitive pricing arrangements.

*Id.* at 129.

As noted by Dr. Selwyn, this type of approach would be consistent with that taken by the FCC in 1995 when it declared AT&T to be a nondominant carrier in the industry. *Id.* at 129. The FCC based its decision, in part, on the fact that AT&T's market share had declined to 60%. *Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier*, Order, FCC 95-427, 11 FCC Rcd 3271(1995).

The Board has the ability to implement its own competition monitoring program in order to obtain a clear and evolving picture of the true state of competition in New Jersey. In its 1993

Order establishing PAR-1, the Board noted, "[i]n determining the competitiveness of services, the Board reserves the right to … [u]se a customer survey to solicit information related to the perception of the level of competition by actual telecommunications users." 1993 Order at 133. This type of survey program would allow the Board to better assess the arguments on the actual state of competition made by Verizon-NJ and competitors in this and many other proceedings. The Alabama Public Service Commission implemented a similar plan to assess the evolving state of competition in Alabama by requiring information from competitors on a monthly basis. *See All Providers of Competitive Local Exchange Service in Alabama*, Informal Docket U-3949, Alabama Public Service Commission Order (Jan. 11, 1999). The Ratepayer Advocate respectfully recommends that the Board consider this approach in establishing its criteria for reclassification.

In this proceeding, Verizon-NJ has failed to provide the Board with evidence of the presence of effective competition. As previously stated, Verizon-NJ's purported "evidence" is little more than a tally of CLECs who have been granted approval to offer service in New Jersey. Verizon-NJ presents no information on market share for the services that it seeks to reclassify because it claims that information on market share is not necessary where a price-constraining environment is demonstrable through information on demand and supply elasticities of the services in question. T.207:17-18 (7/30/01). Verizon-NJ then undercuts its own position, freely admitting that it has conducted no studies of demand and supply elasticities in preparation for this proceeding. T.210:2-25 (7/30/01); RPA Exhs. 11, 57, RPA-VNJ 194, 195. Thus, even by Verizon-NJ's own low standards, it has failed to carry its burden.

#### a. The Board Should Require That Competitors Be Able To Offer Services At Competitive Prices, Terms And Conditions

An analysis of the presence of effective competition should include an examination of whether competitors are able to offer services in the market at competitive prices, terms and conditions. A mere examination of services identified in filed tariffs is not sufficient:

> Although Verizon-NJ made a limited showing of the tariff rates for the most basic CLEC business local service offerings in New Jersey, it did not demonstrate that all of the services that it seeks to reclassify are offered at competitive prices, terms and conditions by CLECs in New Jersey.

Selwyn Direct at 130. Under the additional measure proposed here, Verizon-NJ would be required to demonstrate that each of the 45 multi-line business services proposed for reclassification are offered by competitors at like prices, with like restrictions, and within like intervals.

The experience of small businesses in the market for multi-line telecommunications services establishes that the tariffs of CLECs indicate little or nothing about how the market actually functions. Verizon-NJ has the market power and control over essential facilities to delay and obstruct CLEC provisioning, often resulting in the frustration of the average customer and his or her abandonment of the competitor. The situation was demonstrated very clearly in Dr. Selwyn's Supplemental Direct Testimony on his company's experience in attempting to obtain T-1 service through AT&T. Verizon New England was able to effect its competitor's service offering through its control of bottleneck facilities. *See generally* Selwyn Supplemental Direct. Indeed, in New York, Verizon was assessed significant penalties by the New York PSC and the FCC for its repeated failure to provide competitors with non-discriminatory access to OSS, allowing it to "win back" customers frustrated with provisioning ostensibly provided by competitors. *See* Order Directing Market Adjustments and Amending Performance Assurance

Plan, N.Y.P.S.C. Case 00-C-0008, *et al.* (Mar. 23, 2000); FCC Release, "FCC Ensures Bell Atlantic Compliance With Terms of Long Distance Approval; Bell Atlantic Agrees to Pay Up to $27 Million," (Mar. 9, 2000). This additional measure will help the Board ensure a functioning competitive market for multi-line services and restrain Verizon-NJ in the anti-competitive exercise of market power.

### 2. The Board Should Ensure that Verizon-NJ's UNE Prices Will Facilitate the Development of Competition

Undoubtedly the single greatest enabler of effective competition under the 1996 Act is the availability of UNEs at forward looking cost. "When UNEs are priced above or below cost, efficient competitive carriers are given incorrect economic signals regarding this important method of market entry." Selwyn Direct at 132. More specifically, where UNEs are priced above cost, potential competitors are discouraged from entering the market and are weakened as competitors if they do try to enter; this would account for the low number of UNEs being provided by Verizon-NJ to competitors. *Id.* at 132.

Reclassification of services should be permitted only where the Board is certain that competitors are being afforded a proper opportunity to compete via UNEs. This means that cost-based rates must be (1) approved by the Board, and (2) properly implemented by Verizon-NJ. The Board approved new UNE rates on December 17, 2001. December 17 UNE Order. However, these rates have yet to be implemented by Verizon-NJ. Thus, whether competitors are still subject to discrimination in their implementation remains to be seen. The Ratepayer Advocate respectfully recommends that competitors be granted a period of six months in which to gain experience with new UNE rates. Given that it took four years to recognize and correct the

previous set of UNE rates, six months seems a relatively short period of time in which to determine the effect of the new UNE rates on the market.

Relatedly, proposed reclassification should require a showing of the availability of the UNE Platform ("UNE-P") in the relevant geographic areas.

> The availability of cost-based UNE-P for both existing VNJ customers who 'migrate' in-place to a CLEC, as well as for inbound CLEC customers, will provide the Board with some level of comfort that efficient competitive entry is possible in the relevant geographic area.

Selwyn Direct at 133.

#### 3. The Board Should Require Compliance With The Section 271 Checklist

While the section 271 checklist is not a sufficient criterion upon which to base a conclusion that competition necessarily exists in a given service, it certainly is a necessary criterion to establish that the pre-conditions for competition exist. 1996 Act §271, *codified at* 47 U.S.C. § 271; Selwyn Direct at 130. Such compliance should therefore be included in the standards of competitive service developed by the Board. As the Ratepayer Advocate and other parties have demonstrated, Verizon-NJ has yet to comply with the section 271 checklist due, in part to Verizon-NJ's failure as yet to provide competitors with non-discriminatory access to OSS and a lack of experience with new UNE rates. *I/M/O the Consultative Report on the Application of Verizon New Jersey, Inc., for FCC Authorization to Provide In-Region, InterLATA Service in New Jersey*, Docket No. TO01090541 ("271 Proceeding"). Reclassification should be denied until a showing of full compliance with the section 271 checklist is made.

#### 4. The Board Should Require Service-By-Service Reclassification

One of the risks of reclassification as Verizon-NJ proposes (that is, *en masse* reclassification of all multi-line business services) is that services within that broad description that are not experiencing competition may be masked by those that are. In order to prevent the inadvertent reclassification of services in which Verizon-NJ may continue to exercise market power, the Board should "assess competitive standards on a service-specific basis, or, alternatively, on a group of like services (such as custom calling features)." Selwyn Direct at 131-132. Thus, Verizon-NJ would be required to submit sufficient evidence on each of the criteria for each individual service that it proposes for reclassification.

### 5. The Board Should Require No Adverse Effect on Other Services

Additionally, reclassification of given services should not affect existing services. Thus, for example, the Board should be conscious of the possibility that reclassifying multi-line business services as competitive will enable Verizon-NJ to offer single-line businesses a second line for no extra charge. The addition of a second line would then make the former single-line business customer a multi-line business customer, thereby effectively removing even single-line business service from the ambit of regulation. This situation was recognized by Dr. Taylor T.270:17-272:14 (8/2/01) during the hearing.

This type of manipulation of the regulatory process is not new to Verizon-NJ. In the CTP Proceeding, Verizon-NJ attempted to "bundle" competitive and rate regulated services so that a customer would no longer have been able to procure a single-element service. Selwyn Direct at 131 (citing CTP). Because Verizon-NJ has proven its willingness to manipulate classification in the past, and because of the risk of this sort of behavior to the ratepayers of New Jersey, the Board should add a criterion regarding the likely impact of reclassification on other services.

### 6. The Board Should Require Prompt And Effective Dispute Resolution

Due to its position as the incumbent controlling essential facilities, Verizon-NJ has a superior bargaining position that would enable it to impose onerous terms and conditions on CLECs. Perhaps more importantly, Verizon-NJ is able to delay and otherwise obfuscate any disputes so that competitors are forced to expend valuable resources in obtaining terms and conditions that are already rightfully theirs by law. As Dr. Selwyn points out, while "[f]ailing to address and resolve disputes in a timely manner has no adverse business consequences for Verizon, [such] may prove fatal for new entrants." Selwyn Direct at 133.

The Board has repeatedly recognized the importance of an efficient and effective dispute resolution process for the development and maintenance of effective competition in New Jersey. *See Investigation Regarding Local Exchange Competition for Telecommunications Services*, Docket No. TX95120631 (December 2, 1997) at 128 ("Generic Order"); Status of Local Telephone Competition: Report and Action Plan, Docket No. TX98010010 (July 1998). While the Board adopted the Ratepayer Advocate's recommendation in part, and thereby established an informal dispute resolution process, New Jersey has been without a formalized dispute resolution procedure through the present. Generic Order. The instant proceeding provides an opportunity for the Board to finally complete its examination of the issue and promulgate proposed rules to govern the resolution of disputes between Verizon-NJ and its competitors. Moreover, because of its importance in establishing the existence and continuation of competition in services proposed for reclassification, the Board should add to the existing reclassification criteria a requirement that prompt and effective dispute resolution mechanisms be available to competitors in their dealings with Verizon-NJ.

### 7. The Board Should Require "Air Tight" Service Quality Measures

Finally, the Board should mandate that reclassified services meet service quality standards to prevent backsliding in the provision of those services to consumers once the services are no longer under the direct examination of the Board. Selwyn Direct at 134. As discussed above, these standards should have baseline requirements based on best practices of similar carriers and should be backed up by a strong set of self-effectuating penalties. *Supra* Section III.G. For reclassification of given services, the incumbent should be required to demonstrate that the applicable service quality measures effectively and accurately prevent decreased service quality for competitors *vis-à-vis* Verizon-NJ's own retail subsidiaries.

The Board approved a Performance Assurance Plan to govern the wholesale provisioning of Verizon-NJ on November 1, 2001. *I/M/O the Board's Investigation Regarding the Status of Local Exchange Competition in New Jersey—Performance Standards and Remedies*, BPU Docket N. TX98010010—Item 4B, BPU Agenda Meeting (October 12, 2001). As the penalties included within the Performance Assurance Plan only recently took effect, competitors have scant insight into the Performance Assurance Plan's ability to constrain discriminatory treatment by Verizon-NJ. The Board should require that competitors obtain a minimum of six months of experience with these measures in order to effectively demonstrate any failure of Verizon-NJ to grant non-discriminatory treatment in the provision of wholesale services.

## D. Conclusion Concerning Reclassification

The Board should deny Verizon-NJ's Petition for Reclassification because Verizon-NJ has (1) presented no reliable evidence on the actual state of competition in multi-line business services, (2) failed to present evidence on its claim that it holds no market power in the relevant

services, and (3) otherwise fails the current statutory test for reclassification. If and when Verizon-NJ provides the Board with appropriate and specific information as described more fully herein, the Board should consider reclassification at that time.

Moreover, in promulgating N.J.S.A. 48:2-21.19(b), the Legislature required the Board to develop a set of criteria by which to determine the competitive nature of specific services: "the board *shall* develop standards of competitive service[.]" N.J.S.A. 48:2-21.19(b) (emphasis added). The Legislature thus intended that the Board would consciously address the issue of when a service becomes so competitive as to deserve deregulation. The Board has not yet developed criteria for reclassification as required by the Legislature. The minimum criteria required by statute are necessary and valuable in the examination of potential reclassification, but they are far from sufficient in the determination of the competitive nature of a given service.

The Board should take this opportunity to fulfill its statutory duty and develop a list of criteria for competitive classification. In addition to the minimum criteria presented in N.J.S.A. 48:2-21.19(b), the Ratepayer Advocate recommends that the Board add the following criteria: (1) the presence of effective competition, including the ability of competitors to offer services at competitive prices, terms and conditions; (2) a requirement that UNE rates be set at levels that reflect economic cost; (3) compliance with the section 271 competitive checklist; (4) a requirement for service-by-service reclassification; (5) no adverse effect on other services; (6) the existence of prompt and effective dispute resolution for competitors (including formal procedures proposed and mandated by the Board) ; and (7) the existence of "air tight" service quality measures.

## V. STRUCTURAL SEPARATION

AT&T petitioned the Board to require the structural separation of Verizon-NJ's wholesale operations from its retail operations. *Application of Bell Atlantic-New Jersey Inc. for Approval of an Extension of its Plan for an Alternative Form of Regulation*, Docket No. TO01020095, Answer and Verified Cross-Petition (February 27, 2001). The Ratepayer Advocate supports the concept of structural separation, in which the retail activities of Verizon-NJ would be conducted by an entirely separate affiliate of Verizon, and treated in every way like other competitors in the retail market. *I/M/O Application of Bell Atlantic-New Jersey Inc. for Approval of an Extension of its Plan for an Alternative Form of Regulation*, Docket No. TO01020095, Direct Testimony on Structural Separation of Lee L. Selwyn at 5 ("Selwyn Structural Separation") (August 3, 2001).

As an alternative to separation of wholesale and retail activities into separate corporate affiliates, the Ratepayer Advocate urges the Board to implement functional/structural separation. This would be based on a strong code of conduct backed up by strict accounting requirements and penalties. The Ratepayer Advocate has submitted testimony explaining the bases for and describing the particulars of the proposed code of conduct and the functional/structural separation that it would create. Selwyn Structural Separation, *I/M/O Application of Bell Atlantic-New Jersey Inc. for Approval of an Extension of its Plan for an Alternative Form of Regulation*, Docket No. TO01020095, Direct Testimony on Structural Separation of Scott Hempling (August 3, 2001) ("Hempling Direct").

These steps will benefit ratepayers by creating a structure that has a proven record of encouraging telecommunications competition. Selwyn Structural Separation at 3-4. Either full structural separation or the proposed code of conduct will level the playing field in retail markets

by requiring that Verizon-NJ provide its wholesale services to other firms in a manner that is in every way equivalent to Verizon-NJ's treatment of its retail segment.

### A. Structural Separation Will Minimize the Incentive for Verizon-NJ to Prevent Competition by Favoring its Retail Business Units, its Ability to Engage in that Favoritism, and Unearned Advantages for its Retail Operations

In the 1992 Act the Legislature recognized that competition promotes efficiency, reduces regulatory delay, and fosters productivity, consumer choice and lower prices. N.J.S.A. 48:2.21.16.b(1), -(3). The Board has before it proposals for structural separation that give it the opportunity to be a pioneer in promoting vibrant, effective competition that will achieve these objectives. The Ratepayer Advocate submits that full structural separation or a code of conduct are the proper vehicles for encouraging this competition. Ratepayer Advocate Blossom A. Peretz explained this position to the Board as follows:

> With the goal of bringing true competition to New Jersey's telecommunications market, we are asking the BPU to impose a separation of the Verizon operations. In that way, Verizon's wholesale operations would interact with the retail operation as if it were any other unaffiliated company seeking to provide local telephone service. Under our proposal, structural separation could be implemented by means of an actual separation of the wholesale and retail operations, or it could be implemented through stringent accounting safeguards and a strict "Code of Conduct" that would be enforced by the Board with severe financial penalties.

T. 39:5-21 (8/13/01).

Separation of Verizon-NJ's wholesale and retail operations is called for because past regulatory efforts have not brought widespread, meaningful competition to New Jersey. *Infra* Sections III and IV.D; Selwyn Structural Separation at 2-3. Verizon-NJ's own evidence shows that many CLECs have attempted to enter the local markets in New Jersey. Selwyn Structural Separation at 3; SWT at 41. Despite these efforts by would-be competitors, Verizon-NJ retains a

dominant share of those markets. Selwyn Structural Separation at 3; Selwyn Direct at 102. Clearly, the time has come to move beyond regulatory efforts to promote competition solely by ordering Verizon-NJ to conduct its wholesale business on a non-discriminatory, pro-competitive basis. As we now discuss, structural separation or a code of conduct will do much to eliminate Verizon-NJ's incentive to engage in anticompetitive conduct. Structural separation to promote competition, moreover, is fully supported by precedent, in New Jersey and elsewhere.

Structural separation will promote competition by diminishing the incentives for Verizon-NJ's wholesale arm to favor its retail arm, constraining Verizon-NJ's ability to act on those incentives, and eliminating unearned advantages flowing to Verizon-NJ's retail business.

A firm with a dominant position in a wholesale market has a natural incentive to use that position to boost profits and disable competitors by favoring its retail business units. *See* Selwyn Structural Separation at 3-4; Pennsylvania Public Utilities Commission, *Joint Petition of Nextlink Pennsylvania, Inc.; Senator Vincent J. Fumo; Senator Roger Madigan; Senator Mary Jo White; the city of Philadelphia; The Pennsylvania Cable & Telecommunications Association; RCN Telecommunications Services of Pennsylvania, Inc.; Hyperion telecommunications, Inc.; ATX Telecommunications; CTSI, Inc.; MCI Worldcom; and AT&T Communications of Pennsylvania, Inc. for Adoption of Partial Settlement Resolving Pending Telecommunications Issues; Joint Petition of Bell Atlantic Pennsylvania, Inc., Conectiv Communications, Inc.; Network Access Solutions; and the Rural Telephone Company Coalition for Resolution of Global Telecommunications Proceedings*, Docket Nos. P-00991648, P-00991649, Opinion and Order at 235 ("Pennsylvania Global Order") (August 26, 1999). This results in preferences and advantages for the incumbent's retail business to the detriment of would-be competitors. For example, when

Verizon-NJ's network maintenance force gives speedier service to Verizon-NJ's retail customers, competitors and competition are injured. Hempling Direct at 21. This type of discrimination is difficult to prevent because it is difficult to detect.

Structural separation would create a separate corporation responsible only for wholesale operations. This would greatly decrease incentives to discriminate in favor of Verizon-NJ's retail arm, since wholesale employees and managers would be focused on and measured by their provision of wholesale service, not the success of Verizon-NJ's retail segment. Selwyn Structural Separation at 27; Lehr Reply at 53-54. In addition, the separate identities of the corporations providing wholesale and retail services would enhance the Board's ability to detect instances of improper favoritism toward Verizon-NJ's retail arm. Selwyn Structural Separation at 20-21.

The Bell System divestiture provides a tangible example of the efficacy of structural separation for promoting competition in markets with a dominant provider of wholesale services. Selwyn Structural Separation at 3-4. The centerpiece of the *AT&T* consent decree was the requirement that AT&T divest its monopoly businesses, the local telephone operating companies. *Id.* This "separation" came after years of largely unsuccessful behavioral regulation meant to provide competitors access to the local exchange market and thus nurture long distance competition. *Id.* Once that separation occurred, competition flourished as the former Bell monopolies lost their incentive to discriminate in favor of AT&T. Selwyn Structural Separation at 4. While no party in this proceeding has proposed the complete divestiture that brought competition to long distance markets, the lesson remains. When steps are taken to separate the competitive side of a business from the monopoly side, the incentive to quash competition diminishes, and results can be expected that far surpass the results of behavioral regulation.

Structural separation or a code of conduct would also mitigate the inherent, unearned competitive advantages that flow from integrating Verizon-NJ's monopoly over wholesale services with its retail offerings. One example of these unearned advantages is Verizon-NJ retail's ability to use the Verizon brand name. That name is well known to consumers – and thus valuable – because it is associated with the telephone service that was consumers' only option for many decades, and because it has been the object of extensive promotion funded by monopoly ratepayers. Hempling Direct at 8. Similarly, Verizon-NJ's ability to use its monthly bill to market retail services to nearly every telephone consumer in the state gives it a competitive edge that flows directly from its regulated monopoly and has nothing to do with competition on the merits. *Id.* Other examples of unearned advantages include the massive corporate support infrastructure that subsidizes Verizon-NJ retail, and a large corps of skilled employees that has been built up at ratepayers expense. Hempling Direct at 8. These and similar advantages are unearned because they were made possible by a combination of decades of regulation that excluded competition and funds supplied by ratepayers. Hempling Direct at 6-7. Given this origin, there is no economic, regulatory or other justification for making these advantages available exclusively to Verizon-NJ. Hempling Direct at 7.

### B. Precedent Supports Imposition of Full Structural Separation or Functional/Structural Separation Through a Code of Conduct

There is ample authority, both in New Jersey and elsewhere, to support the Board's imposition of structural separation or a code of conduct. The New Jersey Legislature has recognized the value of structural separation as means of replacing regulation with competition. In the Electric Discount and Energy Competition Act, 1999 N.J. Laws 23, the Legislature

confirmed the propriety of functional or structural separation in the electric and gas industries. In that Act, the Legislature recognized the Board's power to require that a utility provide competitive services through a business unit that is functionally separate from the unit providing monopoly services or from a structurally separate affiliate. N.J.S.A. 48:3-56.f(4) (electric utilities); N.J.S.A. 48:3-58.k(4) (gas utilities). Under the statute's functional separation provisions, the competitive business unit must use a separate corps of employees and separate assets to provide its services. *Id.*

The Board has recognized the benefits of functional/structural separation in its treatment of electric and gas utilities. The Board's Affiliate Relations Standards provide detailed guidance on the relation between the wholesale and retail sides of electric and gas utilities. NJAC 14:4-5.1-5.6 (2000). These Standards address the same structural concerns that are relevant to Verizon-NJ's situation. They strictly prohibit discrimination against competitors and in favor of competitive business segments. NJAC 14:4-5.3. This prohibition more particularly covers access to wholesale products and services, *id,* § 14:4-5.3(b)2, discounts or fee waivers, NJAC 14:4-5.3(f), processing of requests for wholesale service, *id,* § 14:4-5.3(j), and other matters. Under the Affiliate Relations Standards, if an electric and gas utility shares proprietary information with a competitive segment of its business, it must make the information equally available to competitors. *Id,* § 14:4-5.4(a); *see also id,* § 14:4-6(m)2 (non-discriminatory sharing of market information). The Standards also impose a general prohibition on sharing office facilities between wholesale and retail business units, *id,* § 14:4-5.5(e). In addition, the Affiliate Relations Standards require that electric and gas utilities keep separate accounts for each competitive product or service and file related reports with the Board. *Id.* § 14:4-5.6(n), -(p)-(r). Finally,

there are stiff penalties for violating the Standards. *Id.* § 14:4-5.9. The Affiliate Relations Standards covering the electric and gas industries provide a highly useful model for the Board to follow in its efforts to inject competition into New Jersey's telecommunications markets.

The Board's consideration of FirstEnergy Corporation's acquisition of Jersey Central Power and Light Company established the competitive merit of a strong code of conduct. *Joint Petition of FirstEnergy Corp. and Jersey Central Power and Light Company, dba GPU Energy, for Approval of a Change in Ownership and Acquisition of Control of a New Jersey Public Utility and Other Relief*, BPU Docket No. EM00110870, Order of Approval (Oct. 9, 2001) ("FirstEnergy Order"). There, the Board established a code of conduct to regulate dealings between the competitive and non-competitive business units of the merged firm. FirstEnergy Order at 14, 17-18, Att. A ¶¶ 1-10. To prevent any unfair competitive advantage, that Order requires that the firm's non-competitive units transact business with the firm's competitive units in the same manner as they deal with unaffiliated competitors. FirstEnergy Order at 14, 17-18, Att. A ¶ 1(a). This ensures, among other things, that FirstEnergy's non-competitive wholesale business units will not give any preference to its retail affiliates and must provide competitive information to affiliates and non-affiliates contemporaneously and on the same basis. *Id.* at 15, 17, Att. A ¶¶ 1(b), -(c). In addition, the FirstEnergy order requires that the firm conduct its wholesale and retail operations as separate corporate entities, with separate staffs below the senior officer level, and in physically separate locations. *Id.* at 17, Att. A ¶ 2.

In the telecommunications field, the Pennsylvania Public Utilities Commission endorsed using a code of conduct to promote competition. The Commission had ordered full structural separation in an earlier proceeding. Pennsylvania Global Order. After a proceeding meant to

implement that decision, the Commission gave Verizon a choice of either Commission consideration of full structural separation such as that proposed by AT&T in this proceeding or functional/structural separation accomplished via a strict code of conduct. Pennsylvania Public Utility Commission, *Bell Atlantic-Pennsylvania Inc.*, Docket No. M-00001353 at 29 (April 11, 2001) (Pennsylvania Separation Order"). Verizon-PA opted for functional/structural separation under a code of conduct. Pennsylvania Public Utility Commission, *Structural Separation of Bell Atlantic-Pennsylvania Inc. Retail and Wholesale Operations*, Docket No. M-00001353 (April 11, 2001). The Pennsylvania PUC is still considering the details of this code of conduct, but in general it will accomplish what the Commission called "functional/structural separation," *id.* at 30. This approach was similar to what the Ratepayer Advocate supports here, and includes separate books of account for Verizon-PA's wholesale and retail businesses and rules requiring non-discriminatory treatment of retail competitors, *id.*

The Board can rely, therefore, on established regulatory policy, the declarations of the New Jersey Legislature, this Board's own actions in other industries, and the actions of a neighboring state regulator for authoritative support and practical guidance in imposing either full structural separation or functional/structural separation. The Ratepayer Advocate regards either of these approaches as measured, viable means to ensure that Verizon-NJ and its retail competitors compete on a full, fair and equal basis.

### C. The Terms of Any Structural Separation or Code of Conduct Must Thoroughly Eliminate Verizon-NJ's Anticompetitive Preferences and Advantages

The Ratepayer Advocate fully supports the current proposal for structural separation. If the Board does not select that alternative, functional/structural separation with a strong code of

conduct is an absolute necessity to promote competitive conditions in the retail markets that Verizon-NJ now dominates. Ratepayer Advocate Peretz explained the importance of such a Code of Conduct:

> A Code of Conduct is critical to promoting effective competition in the local exchange marketplace. Additionally, the Code of Conduct would contain competitive safeguards and consumer protections that would provide a clear distinction between the activities of Verizon as the incumbent local service provider and those of any other Verizon affiliate that competes with other competitive local exchange carriers.

T. 39:22-408 (8/13/01).

Whether the Board chooses to require full structural separation or functional/structural separation via a code of conduct, the goal remains the same: to eliminate the discriminatory preferences and unearned advantages that now accrue to Verizon-NJ when operating in retail telecommunications markets. These preferences and advantages include cross-subsidization of Verizon-NJ's retail operations by its wholesale activities, Selwyn Structural Separation at 23; consumer perceptions that give Verizon-NJ retail an unearned, anticompetitive marketing advantage, Hempling at 5, 6; and preferential access to economies of vertical integration, Hempling at 6-12. Verizon-NJ's retail competitors must also be put on the same footing when it comes to access to Verizon-NJ's monthly bill; access to customer information; referrals of business leads (including "warm" transfers of customer calls from a wholesale service representative to a retail marketing employee, *see* Selwyn Structural Separation at 23); joint marketing; processing service requests; and the price and quality of wholesale services generally. Hempling at 8. In addition, Verizon-NJ's exclusive use of its corporate name to market its retail

services is an unearned advantage that restrains competition and must not survive structural separation. Hempling Direct at 8.

Structural separation should also be crafted to eliminate as much as possible Verizon-NJ's natural incentive to favor its retail affiliate. Verizon-NJ must be prohibited, therefore, from giving its wholesale employees any special stake in the success of its retail business units.

The Board's action should address both Verizon-NJ's organization and the nature of transactions between Verizon-NJ's wholesale and retail segments. The purpose of the organizational measures that the Ratepayer Advocate recommends is to separate Verizon-NJ's retail and wholesale operations as much as possible. To accomplish this, a code of conduct should include the following:

- The Board should prohibit Verizon-NJ's competitive business units from using the corporate name in any way in their marketing. This name has considerable value that is in large part attributable to the Verizon-NJ's long-held position as a regulated monopolist. It is therefore an unearned advantage, the use of which restrains competition for no defensible reason. Hempling Direct at 14-15.
- To encourage competition for retail services, the code should require Verizon-NJ to undertake a program of education to inform consumers of their right to select a competitive provider at the retail level. Alexander Direct at 37.
- Transfers of personnel between the wholesale and resale sides of Verizon-NJ should be limited. Without such a limitation, the training that wholesale employees receive at ratepayers' expense will subsidize Verizon-NJ's competitive endeavors if they are transferred to a retail business unit. Transfers from a retail to a wholesale business unit will mean that employees who are likely to have a greater interest in granting preferences to Verizon-NJ's retail business will be making decisions about the provision of wholesale services. Hempling Direct at 18-19.
- The Board should forbid the sharing of facilities or employees between the wholesale and retail sides of Verizon-NJ's business. Alexander Direct at 38; FirstEnergy Order at 17, Att. A ¶ 2 (employee sharing prohibited).
- Verizon-NJ should maintain separate books of account for its wholesale and retail arms, with explicit accounting for all transfers of value between those parts of the

firm, using accounting standards to properly value all such transfers. Such a requirement would help to detect anti-competitive cross-subsidies between Verizon-NJ's monopoly operations and its competitive retail businesses. Selwyn Structural Separation at 22-23; Affiliate Relations Standards §§ 14:4-5.6(n), -(p)-(r); -5.7.

- Customers should be given an express opportunity to select among competitive providers of retail services. This "balloting" will help erode the artificial advantage Verizon-NJ now has as a result of its long tenure as a monopoly provider of retail services. Selwyn Structural Separation at 17-18.

Controls on dealings between the wholesale and retail business units are also extremely important in a code of conduct. The Board has already implemented a number of provisions of this type in its regulation of electric utilities. Affiliate Relations Standards, *supra*; FirstEnergy Order, *supra*. The Ratepayer Advocate recommends that, to prevent antitcompetitive discrimination, the Board establish the following requirements for Verizon-NJ's dealings with its own retail operation and its competitors:

- Most generally, the code of conduct should protect retail competition with a prohibition on any form of discrimination. *E.g.,* FirstEnergy Order at 14, 17-18, Att. A ¶ 1(a). This includes a requirement that Verizon-NJ provide its retail unit exactly the same products, services and other benefits as its competitors, with the same prices, terms and conditions, and using the same business processes. Hempling Direct at 21.

- The code should require that Verizon-NJ give all retail competitors access to the billing process, including the same right as Verizon-NJ's retail unit to include marketing information in the monthly bill. This will give all competitors an equal opportunity to benefit from any source of unparalleled access to customers and marketing information. Hempling Direct at 16.

- Customer information should be available to competitors to the same extent and using the same arrangements as it is available to Verizon-NJ's retail operation. Hempling Direct at 17-18; FirstEnergy Order at 15,17, Att. A ¶¶ 1(b), -(c).

- The code should prohibit joint marketing between Verizon-NJ's wholesale and retail arms. Hempling Direct at 20. This would include a prohibition on bundling wholesale and retail products or services. Alexander Direct at 36. Another

important corollary of this prohibition would be to forbid transfers of customer calls from Verizon-NJ's network personnel to Verizon-NJ retail marketing, unless that service is made equally available to all retail firms. Selwyn Structural Separation n. 14; Alexander Direct at 38.

- When customers ask Verizon-NJ wholesale to recommend a provider of a competitive service, the code should require that Verizon-NJ provide objective information or none at all. Hempling Direct at 20.

- When a competitor or its customer requests information available only from Verizon-NJ's wholesale business unit, Verizon-NJ should be required to make the information available as quickly and cheaply as when its affiliate makes the request. Hempling Direct at 21.

- The Board should monitor Verizon-NJ's performance under strict accounting standards, using regular reporting requirements to ensure that neither overt discrimination nor implicit subsidies are retarding competition. Affiliate Relations Standards §§

The code of conduct should be backed up by strict penalties, swiftly applied. Hempling Direct at 21-22; Affiliate Relations Standards §§ 14:4-5.9. Because discrimination that discourages competition can have great long-term benefits for Verizon-NJ, penalties for that discrimination must be weighty. These penalties should, therefore, include financial sanctions that cover the cost of the wrongdoing plus a penalty. Hempling Direct at 23. Equally importantly, the Board should provide for structural sanctions, including measures designed to alter the affiliate relationship to prevent recurrence and in appropriate cases banning Verizon-NJ from the affected retail market. Hempling Direct at 22-23.

### D. Conclusion Concerning Structural Separation

In this proceeding the Board has the opportunity to take an important step to finally bring effective competition to New Jersey. Full structural separation and functional/structural separation with a code of conduct are both proven, established remedies. These remedies are

available, moreover, at a time when other regulatory approaches have failed. The competition that they induce will directly benefit ratepayers by bringing them lower prices and the competitive choices that come with markets that are not dominated by a monopolist. The Ratepayer Advocate respectfully urges the Board to adopt a program of structural separation or a code of conduct that will produce functional/structural separation as described above.

## VI. CONCLUSION

For the reasons expressed above, the Ratepayer Advocate respectfully recommends the following:

**PAR-2**

**Rate Cap:** The Ratepayer Advocate recommends that the Board require that the existing monthly rate for basic residential service be maintained for at least five years.

**Earnings sharing:** The Ratepayer Advocate recommends that the Board require that Verizon-NJ share with ratepayers an amount based on the sum of 25% of Verizon-NJ's return on equity in excess of ten per cent and 25% of total shareholder return in excess of ten per cent, adjusted on the basis of Verizon-NJ's market share.

**Merger savings:** The Ratepayer Advocate recommends that the Board require that Verizon-NJ share with ratepayers savings from the Bell Atlantic-NYNEX and Bell Atlantic-GTE mergers.

**Rate reduction:** The Ratepayer Advocate recommends that the Board effectuate an overall rate reduction of $148 million by consolidating rate centers and expanding local calling areas.

**Refund:** The Ratepayer Advocate recommends that the Board order a one-time refund of $43 million to return to ratepayers merger savings that have already been realized.

**Local Calling Areas:** The Ratepayer Advocate recommends that the Board reduce the number of Verizon-NJ local calling areas from one hundred eighty (180) to twenty-one (21), creating rate centers in each county and local calling areas covering each county and the counties bordering it.

**Residential Service Subsidy:** The Ratepayer Advocate supports including all attendant local services in performing a subsidy analysis for residential service. The Ratepayer Advocate recommends that, because this subsidy analysis reveals that residential service generates a considerable contribution, the Board return excess revenues and merger savings to ratepayers.

**Universal Service:**

*State Universal Service Fund:* The Ratepayer Advocate recommends that the Board establish an independent state universal service fund. This fund should include components for (1) low-income residents; (2) schools and libraries; and (3) residents located in high cost areas of the state. Specifically with regard to schools and libraries, support programs should be available for all schools and libraries regardless of their location within New Jersey and all incumbent and competitive carriers should be able to participate in such programs.

*Lifeline Program*: The Ratepayer Advocate recommends the following improvements be made to the Lifeline program: (1) the maximum amount of assistance available to program participants should be increased to federal maximum level of $10.50; (2) eligibility requirements should be expanded to include all households with incomes at or below one hundred seventy-five percent (175%) of the federal poverty level; (3) enrollment in the program should be simplified, with those

participating by virtue of their enrollment in an existing public assistance program automatically enrolled and those enrolling by virtue of their incomes permitted to self-certify; and (4) the program should be made permanent.

*Access New Jersey*: The Ratepayer Advocate recommends expanding the Verizon-NJ specific Access New Jersey program by (1) increasing its funding to $47 million annually; (2) deepening the discounts for Asynchronous Transfer Mode services and maintaining all other discounts; and (3) extending the program indefinitely.

**Service Quality:** The Ratepayer Advocate supports adopting a new, comprehensive service quality plan that (1) includes additional categories of measurements to capture important areas of customer service and reliability not measured by current standards; (2) replaces the current surveillance and exception level standards with baseline performance standards; (3) establishes self-effectuating penalties for situations where Verizon NJ fails to satisfy these baselines; and (4) includes a code of conduct governing the relationship of Verizon NJ with its affiliates.

**RECLASSIFICATION OF MULTI-LINE BUSINESS SERVICES**

**Requirements for Reclassification:** The Ratepayer Advocate recommends the addition of the following to the minimum criteria for reclassification under N.J.S.A. 48:2-21.19(b): (1) the presence of effective competition, including the ability of competitors to offer services at competitive prices, terms and conditions; (2) a requirement that UNE rates be at levels that reflect economic cost; (2) compliance with the section 271 competitive checklist; (3) a

requirement for service-by-service reclassification; (4) the absence of any adverse effect on other services; (5) the availability of prompt and effective dispute resolution for competitors; and (6) the existence of "air tight" service quality measures.

**Alternative Dispute Resolution:** The Ratepayer Advocate recommends that the Board promulgate proposed rules to govern the resolution of disputes between all telecommunications carriers.

**Verizon-NJ's Petition for Reclassification:** The Ratepayer Advocate recommends that the Board deny Verizon-NJ's Petition for Reclassification. If and when Verizon-NJ provides the Board with appropriate and specific information as required by N.J.S.A. 48:2-12.19, the Board should then consider reclassification.

**STRUCTURAL SEPARATION**

**Full Structural Separation:** The Ratepayer Advocate recommends that the Board order the structural separation of Verizon-NJ's wholesale and retail business units. Verizon-NJ's wholesale and retail operations should be provided by separate corporate affiliates, and the wholesale affiliate should be subject to requirements under which it will treat its retail affiliate and all other retail competitors exactly alike.

**Functional/structural separation:** The Ratepayer Advocate recommends as an alternative to full structural separation that the Board require that Verizon-NJ operate under a strong code of

conduct, backed by strict accounting measures and penalties. The code of conduct should require completely non-discriminatory treatment of Verizon-NJ's retail competitors. Verizon-NJ retail should not be allowed to use the corporate name in its marketing, nor to share or have privileged access to any other Verizon-NJ assets or employees.

Respectfully submitted,

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