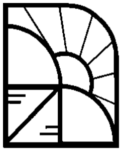

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PHOENIX CENTER POLICY BULLETIN NO. 1:

18 December 2002

In their Own Words: A Review of Recent Bell Operating Company 10-Qs

I. Background

At bottom, the central thrust of the original AT&T Divestiture in the early 1980's was to structurally separate the industry so as to prevent local incumbents from leveraging their market power over the "last mile" into other ancillary markets where entry was easier and competition could take hold, most notably long distance, terminal equipment and data. When the Telecommunications Act of 1996 was enacted, however, the U.S. Government decided that with improvements in technology and a more mature industry, perhaps it might be acceptable to re-vertically integrate the market (*i.e.*, permit dominant firms to once again provide both local and long-distance services) provided that a key caveat was met: Specifically, that the Bell Operating Companies ("BOCs") must make elements of their local network available to rivals on an on a wholesale, *à la carte* basis – commonly referred to as "Unbundled Network Element Platform" or "UNE-P" – so as to mitigate the BOCs' still very real ability to exercise market power both in their core local business as well as in the ancillary markets mentioned *supra*.[1]

While this "trade-off" may have seemed like a great idea in concept, as PHOENIX CENTER POLICY PAPER SERIES NO. 12 explains, policymakers failed to account fully for the economic reality that the structural characteristics of the long distance industry and the local market differ

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[1] Indeed, as the U.S. Supreme Court recently found in *Verizon Communications Inc. v. FCC*, 122 S. Ct. 1646, 1661 (2002):

> *[Incumbent LECs have] an almost in-surmountable competitive advantage not only in routing calls within the exchange, but, through its control of this local market, in the markets for terminal equipment and long-distance calling as well. A newcomer could not compete with the incumbent carrier to provide local service without coming close to replicating the incumbent's entire existing network, the most costly and difficult part of which would be laying down the "last mile" of feeder wire, the local loop, to the thousands (or millions) of terminal points in individual houses and businesses.* The incumbent company could also control its local-loop plant so as to connect only with terminals it manufactured or selected, and could place conditions or fees (called "access charges") on long-distance carriers seeking to connect with its network. *In an unregulated world, another telecommunications carrier would be forced to comply with these conditions, or it could never reach the customers of a local exchange.*

(Emphasis supplied.)

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significantly.[2] Stating the issue colloquially, it is far easier for the BOCs to enter the long-distance segments than it is for rivals to enter the local segment. As a result, it should come as no surprise that while at year's-end nearly 10 million consumers are starting to benefit from competition based upon UNE-P, the BOCs will have access to seventy percent (70%) of all access lines in the United States and will be servicing about 17 million long distance lines.

In a effort to quash this nascent competition in the face of such unprecedented re-vertical integration (not to mention the near total horizontal re-concentration by reducing the number of BOCs from seven to four), the BOCs have recently launched a coordinated campaign to convince both policymakers and stakeholders that their financial woes are attributable to Congressionally-mandated Federal Communications Commission policies necessary to open local telecoms markets to competition. Specifically, that regulators force the BOCs to sell unbundled network elements at their Total Element Long Run Incremental Cost ("TELRIC").[3]

The law, econometrics and their own public filings before regulators simply do not support the Bells' position, however. In fact, despite some recent difficulties, BellSouth, SBC, and Verizon remain extremely financially strong companies that enjoy a growing opportunity to gain customers and revenue as they accelerate their entry into the long distance marketplace. To the extent these companies are financially troubled, the problems reflect bad business decisions as outlined in Section II below. Problems at Qwest are well documented and clearly unrelated to UNE-P or the impact of competition generally.

First, as PHOENIX CENTER POLICY PAPER SERIES NO. 13 explains, in the Supreme Court's landmark case of *Verizon v. FCC*, the Court explicitly held that the wholesale rates calculated at the BOCs' TELRIC as required by the FCC's rules were neither confiscatory (*i.e.*, an

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[2] T. Randolph Beard, George S. Ford and Lawrence J. Spiwak, *Why ADCo? Why Now? An Economic Exploration into the Future of Industry Structure for the "Last Mile" in Local Telecommunications Markets*, PHOENIX CENTER POLICY PAPER SERIES NO. 12 (2001) (http://www.phoenix-center.org/pcpp/PCPP12.pdf); *reprinted in* 54 FED. COM. L. J. 421 (May 2002) (http://www.law.indiana.edu/fclj/pubs/v54/no3/spiwak.pdf).

[3] *See, e.g.*, September 13, 2002 Comments of USTA President Walter M. McCormick: The FCC's UNE-P and TELRIC policies have created "parasites that are content to feed off and weaken the host." Glenn Bischoff, *USTA Calls For the End of UNE-P, TELRIC,* TELEPHONYONLINE.COM (Sept. 13 2002); SBC Press Release (September 17, 2002) where, according to SBC President Richard Daley, TELRIC pricing is "below cost" and is an "irrational and unsustainable subsidy that is threatening the future of our telecommunications infrastructure"; *but c.f.* October 21, 2002 Letter from California Public Utilities Commission Chairman Loretta Lynch to SBC President Ed Whitacre questioning his claims that 2,000 jobs will be lost in California due to "below cost" UNE-P" pricing when: (1) In 2000, 2001 and the first half of 2002, SBC Pacific Bell's earnings per share were nearly double those of SBC overall; (2) In the past two and one-half years, SBC Pacific Bell's profits on its regulated operations have consistently exceeded healthy profit levels; and (3) In 2000 and 2001, rates of profit on regulated assets exceeded the benchmark for healthy earnings by 28 and 25 percent, respectively. (Available at http://www.cpuc.ca.gov/static/announcements/021011_sbc_investigation.htm.)

unconstitutional takings without compensation) nor a subsidy.[4] In fact, there is no evidence that *any* State regulatory proceeding has found to date that BOC wholesale rates for UNEs are confiscatory; to the contrary, State commissions have found the majority of these UNE rates to be excessive and "creamy returns" and ordered these rates to be reduced to within the "zone of reasonableness."[5]

Second, contrary to the BOCs' criticisms of State ratemaking proceedings (proceedings which, incidentally, are open for public participation and were recently described by the United States Supreme Court in *Verizon* as "smoothly running" affairs[6]), PHOENIX CENTER POLICY PAPER NO. 16 reveals that the States have been extremely careful to ensure that TELRIC rates accurately reflect the Bells' forward looking costs. Moreover, the States have actually preserved some BOC profit in a politically-sensible "50/50" split between the desired outcomes of new entrants and the incumbents. Accordingly, the fact that BOC margins are declining is an intended consequence of the Telecommunications Act 1996 and a rational public policy that, deliberately, does not incorporate the monopoly rents the Bells have traditionally enjoyed in the wholesale prices for unbundled network elements.[7]

Third, the BOCs' argument is particularly odd under any scenario because the BOCs will lose *more money* if they lose a customer to a facilities-based competitor outright. As PHOENIX CENTER POLICY PAPER NO. 15 demonstrates, when losing a customer to a facilities-based provider, the BOCs would: (1) receive no revenue for that last line; and also (2) would continue to incur the sunk costs of building their respective networks out to that customer in the first instance. With UNE-P, however, the BOCs still receive a steady revenue stream from that line

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[4] *Verizon Communications Inc. v. FCC, supra* n. 1. For a full discussion of the *Verizon* Opinion and the current FCC broadband initiatives, *see* Lawrence J. Spiwak, *The Telecoms Twilight Zone: Navigating the Legal Morass Among the Supreme Court, the D.C. Circuit and the Federal Communications Commission*, PHOENIX CENTER POLICY PAPER SERIES NO. 13 (August 2002) (http://www.phoenix-center.org/pcpp/PCPP13Final.pdf); COMMUNICATIONS WEEK INTERNATIONAL, *Opinion: U.S. Competition Policy – The Four Horsemen of the Broadband Apocalypse* (01 April 2002) (available at http://www.phoenix-center.org/commentaries/CWIHorsemen.pdf).

[5] For a comprehensive yet easy to understand primer on basic ratemaking, *see* Mark Naftel and Lawrence J. Spiwak, The TELECOMS TRADE WAR: THE UNITED STATES, THE EUROPEAN UNION AND THE WTO (Hart 2001).

[6] Indeed, the very idea that State regulators, after full opportunity for public participation (including cross examination) and review by the courts have somehow all uniformly acted in some "vast Federalist conspiracy" to set UNE rates below the BOCs' costs strains credulity. For this reason, the States have rightly taken umbrage the BOCs' attacks on both their jurisdiction and competencies. *See, e.g.,* National Association of Regulatory Utility Commissioners' September 27, 2002 letter to Senate Majority Leader Thomas Daschle; National Association of Regulatory Utility Commissioners' November 20, 2002 *Ex Parte* letter in *In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket Nos. 01-338, 96-98 and 98-147, Notice of Proposed Rulemaking, FCC 01-361 (rel. Dec. 20, 2001).

[7] T. Randolph Beard and George S. Ford, *What Determines Wholesale Prices for Network Elements in Telephony? An Econometric Evaluation,* PHOENIX CENTER POLICY PAPER NO. 16 (September 2002) (http://www.phoenix-center.org/pcpp/PCPP16.pdf).

that covers their forward-looking costs of these facilities plus a reasonable rate of return. The only plausible explanation of this apparently economically irrational behavior is that the BOCs' fully understand that facilities-based competition will be nascent for the foreseeable future and, as such, eliminating UNE-P virtually assures the BOCs' ability to recover monopoly rents from their dominance of the "last mile."[8]

Finally, PHOENIX CENTER POLICY PAPER NO. 17 finds that the Bells are, in fact, profitable wholesale suppliers of unbundled network elements as required by the 1996 Telecommunications Act.[9] Specifically, PHOENIX CENTER POLICY PAPER NO. 17 estimates that: (a) wholesale operating costs are about $10 per line across the BOCs; (b) EBITDA (earnings before interest, taxes, depreciation and amortization) margins are positive and average over $14 per line per month; and (c) operating margins (or EBIT, earning before interests and taxes) are also positive, and average 40% of revenues.

Summary of Findings

	UNE-P Revenues	Wholesale Costs	EBITDA Margin	EBIT/Operating Margin
Verizon	24.43	10.42	14.00	9.42
BellSouth	32.80	9.46	23.33	18.75
SBC	20.57	9.91	10.67	6.08
Qwest	24.63	9.93	14.70	10.12
BOC-Wide	24.43	9.99	14.43	9.85

While in conflict with the conclusions of many financial analysts, the Paper's findings are supported by the recent statements of SBC's Chief Financial Officer, Randall Stephenson, who reported to the investment community that UNE-P per-line revenues of $20 to $21 were sufficient to allow SBC to "earn money" and did not give the company a "disincent[ive] to invest." The Paper indicates that, on average, UNE-P prices of about $20 are fully remunerative to the BOCs in the sense of providing a positive operating margin.

Equally as significant, Professors Beard and Klein subject the conclusions of the various Wall Street analyst reports so heavily relied upon by the RBOCs to careful scrutiny, and find

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[8] *See* George S. Ford, *A Fox in the Hen House: An Evaluation of Bell Company Proposals to Eliminate their Monopoly Position in Local Telecommunications Markets*, PHOENIX CENTER POLICY PAPER NO. 15 (September 2002) (http://www.phoenix-center.org/pcpp/PCPP15%20Final.pdf) ; *see also* Thomas W. Hazlett & George S. Ford, *The Fallacy of Regulatory Symmetry: An Economic Analysis of the "Level Playing Field," in Cable TV Franchising Statutes* 3 BUSINESS AND POLITICS 21 (2001) (available for download at: http://www.egroupassociates.com/Reports/fallacy.pdf) (incumbents understand all too well the economics of facilities-based entry, and therefore "strategically compete in the political realm to create legislation that protects rents of established operators")..

[9] T. Randolph Beard and Christopher C. Klein, *Bell Companies as Profitable Wholesale Firms: The Financial Implications of UNE-P*, PHOENIX CENTER POLICY PAPER NO. 17 (November 2002) (http://www.phoenix-center.org/pcpp/PCPP17Final.pdf).

that they are replete with errors in both the calculation of unbundled element revenues and in the wholesale costs of providing unbundled elements. Accordingly, the authors again remind everyone that because these analysts' reports are intended exclusively to provide investment advice, they are not useful for evaluating the social impacts of required element sales and, therefore, should not provide the basis for public policy decision-making.

II. In Their Own Words

So where are the Bell's really losing money? A review of the BOCs' own recent 10-Q filings with the Securities and Exchange Commission reveal that the BOCs' losses resulted – not from acting as a wholesale provider of unbundled network elements – but from business *faux pas* that occurred in the *unregulated* portion of their businesses.[10] For example:

A. *SBC*

2002 Special Items:

- SBC took combined charges of $$413 ($265 net of tax) for the first nine months (recorded in operating expenses) for enhanced pension benefits and severance costs related to a force-reduction program.
- SBC took a charge of $19M ($12M net of tax) for the first nine months (recorded in operating expenses) for SBC's proportionate share of severance and restructuring costs at Cingular (their wireless operator which is co-owned with BellSouth).
- SBC took a charge of $101M ($68M net of tax) for the first nine months (recorded in equity in net income of affiliates) representing its proportionate share of restructuring costs at Belgacom S.A. (Belgacom is the incumbent local exchange provider in Belgium.)
- SBC had additional bad debt reserves of $125M ($84M net of tax) for the first nine months (recorded in operating expenses) as a result of the July 2002 WorldCom bankruptcy filing.

2001 Special Items:

- SBC took combined charges of $401M ($261M after tax) related to valuation adjustments of Williams Communications Group, Inc.
- SBC took combined charges of $316M ($205M after tax) related to impairment of SBC's cable operations.

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[10] Due to Qwest's internal accounting problems, Qwest has not filed a 10-Q with the Securities and Exchange Commission for over a year. As such, only 10-Qs from SBC, Verizon and BellSouth could be reviewed and analyzed.

- SBC took combined charges of $390M ($262M after tax) related to a transaction pending as of 12/31/01 to reduce the direct and indirect book value of SBC's investment in Telecom Américas.

- SBC took combined a charge of $197M for costs related to TDC A/S's (TDC) (formerly known as Tele Danmark A/S – the incumbent operator in Denmark) decision to discontinue non-wireless operations of its Talkline subsidiary and SBC's impairment of the goodwill it allocated to Talkline.

B. *Verizon*

- In connection with the Bell Atlantic Corporation-GTE Corporation merger, Verizon incurred $1,931 million through the second quarter of 2002 in transition costs, and expects to incur a total of approximately $2 billion of transition costs through the end of 2002.

- During the second quarter of 2002, Verizon recorded a pretax loss of $3,558 million ($3,305 million after-tax, or $1.20 per diluted share), including a loss of $2,443 million ($2,443 million after-tax, or $.89 per diluted share) related to its interest in Genuity Inc.

- During the second quarter of 2002, Verizon recorded a pretax loss a loss of $580 million ($430 million after-tax, or $.16 per diluted share) to the market value of its investment in TELUS, the largest telecoms operator in Western Canada.

- During the second quarter of 2002, Verizon recorded a pretax loss of $303 million ($201 million after-tax, or $.07 per diluted share) to the market value of its investment in Cable & Wireless plc (C&W); during the third quarter of 2002, Verizon recorded another pre-tax loss of $101M ($74M after tax or $0.03 per diluted share) to market value related to Verizon's investment in C&W.

- During the second quarter of 2002, Verizon recorded a pretax loss of $232 million ($231 million after-tax, or $.08 per diluted share) relating to several other unspecified investments.

- During the second quarter of 2002, Verizon recorded a pretax loss of $1,400 million ($1,400 million after-tax, or $.51 per diluted share) of its investment in CANTV, the incumbent local exchange provider in Venezuela.

- During the second quarter of 2002, Verizon recorded a pretax loss of $516 million ($436 million after-tax, or $.16 per diluted share) of its investment in Metropolitan Fiber Networks (MFN).

- During the second quarter of 2002, Verizon recorded a pretax loss of $230 million ($190 million after-tax, or $.07 per diluted share) of its investment in the Argentine mobile

operator CTI. This write-down follows a recorded estimated loss in CTI loss of $637 million ($637 million after-tax, or $.23 per diluted share) in 2001.

- All told, Verizon reported that for the nine months ending September 30, 2002, Verizon was forced to recognize pre-tax loses totaling $2,146 million ($2,026 million after-tax, or $0.74 per diluted share) related to Verizon's investments in CANTV, MFN and CTI.

- During the second quarter of 2002, Verizon recorded pretax charges of $394 million ($254 million after-tax, or $.09 per diluted share) primarily resulting from a pretax impairment charge in connection with its financial statement exposure to WorldCom, Inc. of $300 million ($183 million after-tax, or $.07 per diluted share) and other pretax charges of $94 million ($71 million after-tax, or $.02 per diluted share).

- During the second quarter of 2002, Verizon recorded a pretax charge of $175 million ($114 million after-tax, or $.04 per diluted share) related to a proposed settlement of a litigation matter that arose from its decision to terminate an agreement with NorthPoint Communications (a bankrupt "DLEC") to combine the two companies' DSL businesses.

C. *BellSouth*

- BellSouth took a one-time charge in 2002 related to the adoption of new accounting rules for goodwill, known as Statement of Financial Accounting Standard No. 142 (SFAS No. 142), reducing the value of goodwill on the company's balance sheet by approximately $1.3 billion.

- Over the past several years, BellSouth was forced to write down nearly $383 million in bad shareholder loans from two Brasilian mobile operators. In the event of sale or liquidation of this investment, BellSouth's cumulative foreign currency translation losses related to these investments were $262 million as of September 30, 2002.

- BellSouth owns an interest in CRM, a wireless company in Argentina. Not only has BellSouth recorded foreign currency transaction losses of $672 million in 2002, but also CRM has violated covenants and/or not paid on its $320 million on its U.S. dollar denominated debt to BellSouth.

- In the second quarter 2002, BellSouth recorded a charge of $357 million, or $225 million after tax, related to its plans to reduce its workforce by approximately 500 positions to reduce operating costs in response to "the slow economy, increased competition, and regulatory pricing pressures."

And, to the extent the BOCs' incurred so-called "losses" in their regulated sections, these so-called "losses" were comprised exclusively from significant fines levied by regulators for recurring service problems and anticompetitive conduct.[11]

III. Conclusion

The fact is that 2002 has been a difficult year financially for much of American industry, the Bells included. But these difficulties reflect a variety of external circumstances, including the general economic sluggishness and the Bells' own business decisions. While the shift of some lines to wholesale UNE-P service does reduce Bell revenues relative to retail service, wholesale sales nonetheless generate positive revenues.

More importantly, as demonstrated in the chart below, the Bells' respective consolidated returns for the first nine months of 2002 continue to demonstrate that they are among the strongest companies in America, with revenues from wireline telecommunications products and services alone in the multi-billion dollar range:

	BellSouth[12]	SBC[13]	Verizon[14]
Wireline Segment Revenues:	$ 13,968 M	$ 29,167 M	$ 30,685 M
Net Wireline Segment Income:	$ 2,208 M	$ 4,973 M	$ 3,334 M

Given the above, the Bells – or at least BellSouth, SBC and Verizon – fundamentally remain strong, financially viable businesses that cannot make the case for regulatory policy changes on the basis of financial difficulty.

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[11] (*See, e.g.,* Voices for Choices August 27, 2002 Release (http://www.voicesforchoices.com/1091/wrapper.jsp?PID=1091-23&CID=1091-082702A) (SBC has the ignominious honor of being the first Bell Company to exceed $1 billion in fines levied by municipal, State and Federal authorities for seeking to sabotage competition in its territories); *SBC Faces a $6 Million Fine FCC Largest Penalty Ever,* WALL STREET JOURNAL (October 10, 2002); Yochi Dreazen, *SBC Will Pay Record FCC Fine for Submitting False Information* WALL STREET JOURNAL (May 29, 2002).

[12] BellSouth defines their wireline segment as their "Communications Group" which includes its core domestic business including all domestic wireline voice, data, broadband, e-commerce, long distance, Internet services and advanced voice features. This group provides these services to an array of customers, including residential, business and wholesale.

[13] SBC describes their wireline services segment as landline telecommunications services, including local and long distance voice, switched access, messaging service, and data.

[14] Verizon describes their wireline segment as "Domestic Telecom" which provides all fashions of local telephone services, including voice and data transport, enhanced and custom calling features, network access, directory assistance, private lines and public telephones in 29 States and the District of Columbia.

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