

**Current Federal and State Policy Issues  
Pertaining to Verizon Communications and  
Broadband Deployment In Massachusetts**

A background briefing for the  
Mass Broadband Initiative  
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A Joint Project of the Massachusetts Technology Collaborative and  
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This background briefing paper was drafted by the Massachusetts Technology Collaborative to help the Mass Broadband Initiative advisory committee understand the context of several important regulatory issues affecting Verizon and its competitors, not only in Massachusetts but in the country as a whole. These issues have taken on added importance as the current economic downturn has led to the bankruptcy or downsizing of many Competitive Local Exchange Carriers (CLECs), which were established to compete directly with Verizon and the other Baby Bells (Qwest, BellSouth, and SBC Communications).

The troubles in the CLEC industry have rippled back into the telecommunications equipment industry (including companies in Massachusetts), and have raised the bar for local Internet access projects (such as those represented on our Mass Broadband Initiative advisory committee), which are organized to create facilities-based competition at the local level.

The attached memo was drafted by MTC. (*Errors, omissions and mischaracterizations are entirely our own !!!!*). It provides background information on Verizon and several of the key issues, including:

- At the federal level, the ongoing debate over lifting regulatory constraints on the Bells companies, including constraints which the Bells claim have hindered their investment in high-speed data communications.
- At the state level, the pending DTE action regarding Verizon's pricing of services to business. The DTE is due to rule on a new price plan this Fall.

## ***Verizon-Massachusetts and The Current State of Regulation of The Regional Bell Companies: An Overview***

As the so-called Competitive Local Exchange Carriers (CLECs) have fallen on hard times, issues relative to the regulation of Verizon and the other regional Bell companies have taken center stage at both the federal and state levels.

At the federal level, some in the Bush Administration and the U.S. House of Representatives have suggested that federal mandates requiring the Bells to provide their competitors with access to their networks have acted to stifle new investment by the Bell companies in their own networks infrastructure. Critics charge that federal requirements which force the Bells to act as *wholesalers* to their competitors have retarded the Bells' performance as *retailers*, without sparking the growth of financially viable competitors.

At the state level, a six-year old regulatory order that governs the pricing of Verizon's services in Massachusetts will expire in late August. Verizon proposes to replace the current agreement with a new pricing structure that will largely freeze current residential prices while substantially deregulating prices on services to business customers. Heretofore, Verizon has been compelled to offer services at prices that are uniform statewide (although mileage-sensitive charges, which factor heavily in the pricing of data and Internet services, yield charges which are often wildly different from one part of the state to the next.) Verizon's new proposal would establish floor prices statewide (to prevent predatory pricing on its part), but would otherwise allow the company to differentiate prices according to local market conditions.

### ***Verizon as Wholesaler***

For decades federal law has required the Bell companies to allow competitors rights of interconnection to the Bell networks' systems and those of competitors. Without interconnection, no competitor could connect a phone call between its customers and the vast customer base of the Bell companies.

The Telecommunications Reform Act of 1996 went a great deal further, however. The Telecom Reform Act not only preserves broad rights of interconnection. It also compels the regional Bell companies to provide what are, in effect, *wholesale* services to their competitors.

Under the Act, competitors are allowed the right to "collocate," or install and maintain equipment in the Bells' Central Offices. The competitors are also allowed to lease a wide variety of specific elements of the Bells networks, including individual

copper telephone lines (or “local loops”), and elements of the Bells’ circuit switching equipment.

The Telecom Reform Act and subsequent FCC regulation define these so-called “Unbundled Network Elements” (or “UNEs”), and FCC regulations have created mechanisms to calculate and set prices for each. (The pricing system mechanism is known as TELRIC, for Total Element Long-Run Incremental Cost system.)

Taken together, the mandates on wholesale services allow competitors to utilize the Bell networks either by purchasing services from the Bell companies at wholesale rates and re-selling them to customers at retail rates, or by leasing only as much of the Bell network as the competitor needs to complement its own equipment and network facilities, and providing retail service on that basis, (“facilities-based competition”).

In providing leased lines and other UNEs to competitor companies, Verizon and the other Bell companies are frequently required to dispatch service personnel to central offices, telephone poles, or other facilities to reconfigure wires or electronic gear. Thus, the Bells’ responsiveness and quality of service to competitors has been at issue since the passage of the 1996 Telecom Reform Act. Federal approval of the Bells’ entry into long-distance telephone markets was conditioned upon a demonstration by each Bell company, on a state by state basis, that it had met fourteen measures of network-readiness and quality of service. (This requirement is spelled out in Section 271 of the Telecom Reform Act, and hence the long-distance approval process is frequently referred to as the “271 process,” while the Bells refer to the quality-of-service tests as the “fourteen point checklist.”)

Late last year (2000) the Massachusetts Department of Telecommunications and Energy (DTE) found Verizon to be in compliance with the fourteen-point checklist within the Commonwealth, and approved Verizon’s request for entry into the long-distance telephone market. DTE ordered Verizon to maintain compliance with the fourteen-point checklist, and reserves the right to levy fines on the company for non-compliance. The FCC ratified the DTE decision in March, but only after delaying approval for about two months in order to investigate complaints from competitive DSL providers that Verizon had not maintained necessary levels of service to DSL providers in the provisioning of new lines and other network elements.

***The federal mandates on interconnection, UNEs, and other requirements on the Bells’ wholesale activities are at the heart of the current debate on the deployment of broadband in the post-Bull Market era.***

Verizon and the other Bell companies assert that the Telecom Reform Act has been enforced to compel them to act as wholesalers for providers of data services, when the real intention of the bill’s drafters was to force open voice telephony markets by compelling the Bells to act as wholesalers to telephony companies. Under the law, “data CLECs” are allowed to lease a wide range of other network elements that the Bells would otherwise configure only for their own data businesses.

Verizon and the other regional Bell companies charge that these requirements represent an unduly high level of “forced access” to their network infrastructure, to the benefit of competitors who are far less heavily regulated. Their loudest complaint concerns the still-embryonic mass market for residential high-speed Internet access. The Bells entered the market with DSL service well after it was jump-started by the cable modem industry (e.g. AT&T Road Runner). Verizon and the Bells protest that DSL deployment requires a wide range of new investments in its infrastructure to support what should be considered an entirely new product. From the Bells’ standpoint, DSL-related investments should be exempt from Telecom Reform Act regulations that compel the new investments to be shared on a wholesale basis with DSL competitors.

In short, the Bells insist that “forced access” dilutes their incentive to invest aggressively in their own networks, since any investment they make must be made available to their competitors. Conversely, they believe that “forced” or overly broad rights of network access dilutes the incentives for competitors to build their own facilities, since the competitors have the option of piggy backing onto investments and network upgrades that the Bells make in the Bell-owned systems.

One of the best current illustrations of this point is the controversy over SBC Communications’ “Project Pronto.” Project Pronto is SBC’s \$6 billion program to extend DSL service to 80 percent of its customers over three years. (Verizon does not have a similar strategy at this time.) SBC’s strategy is to extend the reach of DSL service beyond its conventional limits by installing DSL hardware (or “remote DSLAMs”) at the neighborhood level. SBC’s remote DSLAMs are connected to the existing SBC central offices by new fiber optic lines. Thus Project Pronto has the effect of pushing fiber optic lines much closer to residential users, and thus towards the industry’s long-sought goal of “fiber to the curb.”

However, remote DSLAMs are not treated as Unbundled Network Elements by the FCC, and thus competitors are not allowed access to them on a wholesale basis. On his last day in office, former FCC Chairman William Kennard issued an order (not yet enforced) that would compel SBC and the other Bell companies to share access to the new fiber optic lines themselves, but as of now the remote DSLAMs remain off-limits to competitors.

In the Congress, debate over the interconnection and facilities-sharing centers upon the “Internet Freedom and Broadband Deployment Act,” filed by Representatives Billy Tauzin and John Dingell. The Tauzin-Dingell bill would provide the Bell companies with “inter-LATA data relief.” Under the 1996 Telecom Reform Act, the Bells are prohibited from transporting data, including Internet data, across the boundaries of Local Access and Transport Areas (“LATAs”). (LATA boundaries coincide roughly with the nation’s original area code boundaries. Massachusetts has two LATAs that correspond to the original 617 and 413 area codes.) Under current rules, the Bell companies must hand-off data traffic to competitors or Internet Service Providers at the

LATA boundary lines; the Tauzin-Dingell legislation would allow the Bells to provide national data transmission without restriction.

While it would lift the prohibition on inter-LATA data transmission, the Tauzin-Dingell bill would not substantially change the existing rules on interconnection and access to the Bells' network elements. Reacting to controversy generated by Tauzin-Dingell, new FCC Chairman Michael Powell recently reaffirmed his intention to strictly enforce the interconnection and network element rules, and is now seeking Congressional approval for an increase in penalties, which can be levied upon the Bells for non-compliance or poor performance under the current rules, regarding provision of wholesale services.

Moreover, it is thought that Verizon has a strong reason to follow-through on the Section 271 process in every state in which it competes. Under terms of its 1999 merger with GTE, GTE spun-off its Internet Service Provider, Burlington (MA)-based Genuity Corporation. Verizon owns a 9 percent ownership stake, and can purchase upwards of 82 percent ownership, if and when it wins approval for long-distance service covering 95 percent of its current customer base.

As of this writing, it is not yet clear when the full House of Representatives will act on Tauzin-Dingell. Prospects for the bill are mixed in the U.S. Senate, where Bell critics are more powerful, if not more numerous.

Among the reasons cited by Tauzin-Dingell opponents:

- The last five years have represented a difficult but unavoidable shakedown cruise for the Telecom Reform Act and the CLEC industry. Congress should be wary of adopting new laws that will change the rules for the CLECs that, for all their troubles, still constitute a large industry that employs hundreds of thousands and purchases billions of dollars in the cutting-edge telecom technology from the nation's equipment makers and software developers.
- The Bell companies have not generally acted as industry innovators in data communications. The mass market in high-speed Internet connectivity was created by the cable TV industry (through cable modem service), and by "data CLEC" DSL providers, albeit many of them now gone. Innovation has been driven by competition, and national policy should encourage multiple competitors.

Even if the Tauzin-Dingell legislation does not pass this year, interconnection and facility-sharing issues are likely to dominate the national debate on broadband deployment for some time. For one thing, until radical advances in cable modem, wireless or satellite Internet service fuel faster deployment of those technologies, Internet access over copper wires is likely to remain dominant. (DSL subscribers are expected to outnumber cable modem subscribers sometime before 2003.) In the absence of debate

over other policy measures, the debate in Congress over broadband deployment will continue to focus on the role of the Bells, with or without inter-LATA data relief.

### **Verizon as Retailer**

While the Telecom Reform Act of 1996 compelled the regional Bell companies to act as telecom wholesalers, the Bells' retail business remains the biggest source of network traffic and revenues, by a wide margin. Moreover, as the still-dominant provider of "last mile" connectivity, Verizon's plans for retail service and retail service upgrades remain a critical consideration for the long-range future of broadband deployment in Massachusetts.

Verizon's retail business is regulated at the state level by the Department of Telecommunications and Energy (DTE), and all services are priced according to uniform tariffs, applicable state-wide, that are approved by the DTE after adjudicatory proceedings.

Historically, the DTE and its predecessor agency regulated prices under comprehensive orders that controlled the telephone company's rate of return on investment. For decades both telephone service demand and telecommunications technology changed incrementally. Rate-of-return regulation was meant to prevent overbuilding by the telephone company, and thus to guarantee the lowest prices to customers. Rate-of-return regulation also entailed a series of cross-subsidies that shifted the telephone company's cost burdens onto business customers, in order to reduce prices for residential customers.

Beginning in the mid-1980s and continuing through the 1990s, Massachusetts regulators have moved in steps to end rate-of-return regulation and cross-subsidies, and to replace both with regulatory schemes that encourage investment in new technologies and innovations that promise to drive down unit prices to customers.

The most recent pricing plan was adopted six years ago, and is due to expire at the end of August (2001). The plan imposes a series of price caps on Verizon services. The caps are subject to yearly adjustments, both upward for inflation, and downward to reflect productivity increases in both the general economy and the telecommunications industry. The current productivity adjustment is calculated at 4.1 percent, which is designed to produce a yearly rate decrease for most customers, absent a large offsetting increase in inflation. The productivity adjustment is meant to give Verizon an ongoing incentive to improve efficiency and innovation in its operations and services. The price cap system also imposes quality-of-service targets on the company, and allows the DTE to levy fines for non-compliance with the targets.

Earlier in the year the DTE asked Verizon to submit a proposal for a new pricing scheme to replace the price cap system due to expire in August. Verizon has responded

with a proposal that will leave freeze current residential rates, but will deregulate the prices of services to business customers in Massachusetts.

Under the Verizon proposal, a minimum or floor price will be established for each Verizon service to business. The floor price is meant to provide protection to competitors against predatory pricing by Verizon. Verizon would have nearly complete freedom to charge prices above the floor level, depending on what the market will bear in the various regions of Massachusetts. The new proposal would eliminate uniform, statewide pricing for business services. It will also eliminate the productivity factor used to calculate prices for all services, residential and business.

Verizon makes several arguments in favor of the new proposal:

- Competitors now control about 15 percent of all the telecom access lines (or “access line equivalents” – ALEs) in Massachusetts, one of the highest proportions of market penetration by competitors in the country. Thus Verizon asserts that true market competition is underway in Massachusetts. Under these circumstances, a continuation of uniform pricing for business services will lead to distortions in its investment strategy. Capital investment will not be deployed to areas of highest demand and highest return.
- If Verizon fails to compete aggressively for corporate business, other customers in Massachusetts will shoulder a disproportionate burden for cost-recovery of investment in the Verizon network. To the extent that Verizon loses high-margin customers because of any inability to compete, lower-margin customers in less prosperous areas of the state will shoulder a bigger share of the company’s sunk costs in network infrastructure.
- Adoption of non-uniform, deregulated prices will send an appropriate market signal to competitors in under-served areas, because the discount prices for wholesale services (leased lines, UNEs, etc.) will still be set under the TELRIC system established by the FCC. If Verizon raises prices in underserved areas, competitors can opt to keep their prices level --- and claim more market share – or to raise their own prices, while retaining a price margin advantage over Verizon services.

Verizon further contends that deregulation of business prices is crucial to the company in its ability to bundle services (long distance telephone, local telephone, data service, etc.) and thus compete effectively with less-regulated competitors.

Traditionally, the Massachusetts Attorney General intervenes in all telephone company rate cases on behalf of Massachusetts consumers, and to enforce Massachusetts law that calls for regulated utilities to charge “just and reasonable rates” for all services.

Attorney General Tom Reilly filed a series of questions on the Verizon price plan in late May, which can be summarized as follows:

- **Competition:** The Attorney General contends that Verizon should not be allowed to charge deregulated prices to business customers, unless and until the DTE finds that price competition actually exists throughout the state. Pursuant to the Telecom Reform Act, the DTE and the FCC allowed Verizon into the long-distance market based on evidence that the Massachusetts market is open to competition, not that viable competition exists throughout the state. The Attorney General asks the DTE to determine the extent of competition actually present throughout the Commonwealth.
- **“Just and Reasonable Rates”:** The Attorney General notes that the productivity factor created under the existing price cap scheme is designed to give Verizon an incentive to earn “an above-average return for above-average performance.” Currently, Verizon retail prices are automatically reduced 4.1 percent per year, offset only by inflation, or by lower structural costs achieved through efficiencies and innovation. The Attorney General asks for evidence that elimination of the productivity factor will be in the public interest.
- **Costs of service:** The Attorney General asks for a cost-allocation study that assigns appropriate shares of Verizon’s operating and capital costs to its products and to the regions it serves in Massachusetts. According to the Attorney General, the DTE must announce a justification for determining that costs are “just and reasonable,” and no cost allocation study has been completed in the last ten years.
- **Alternatives:** The Attorney General asks the DTE to entertain alternative pricing proposals from third-party sources.