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Committee on Commerce, Science, and Transportation

Good Morning Mr. Chairman and members of the Committee.

My name is David W. Rolka, Senior Vice President of Rhoads & Sinon LLC, a consulting firm located in Harrisburg, Pennsylvania. Prior to joining the consulting firm of Rhoads & Sinon LLC, I served as a member of the Pennsylvania Public Utility Commission (December 1989 – September 30, 1999). During my tenure at the Commission, I co-sponsored the motion, adopted by the Commission, which among other things, directed Bell Atlantic-Pennsylvania, Inc., (VZ-PA) to file a plan that creates a structurally separate affiliate to supply retail telecommunications services.

It was our conclusion<sup>1</sup> that structural separation of retail and wholesale operations is the most efficient tool to ensure the successful development of fair and nondiscriminatory local telephone competition. Following on our state's successful implementation of electric competition, we found that the division of retail and wholesale operations is particularly necessary where a large incumbent monopoly controls the vast majority—around 90% at the time of the vote--of local exchange access lines in its service territory. Equally important, VZ-PA continues to control bottleneck facilities that competitors must have fair and nondiscriminatory access to in order to compete, in virtually all local exchange markets where it currently operates<sup>2</sup>. The overwhelming competitive presence and concomitant ability to exercise market power, including the ability to provide itself with anti-competitive,

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<sup>1</sup> Opinion and Order, P-00991648 and P-00991649, entered September 30, 1999, Chairman John M. Quain, Commissioners David W. Rolka, Nora Mead Brownell and Aaron Wilson, Jr. in accord. Vice Chairman Robert K. Bloom dissenting (*Global Order*).

preferential treatment and cross-subsidies, and the corresponding opportunity and incentive to discriminate against competing telecommunications carriers in the provision of wholesale services, strongly supports the Commission's conclusion in September 1999 that structural separation is necessary to provide the local service competition envisioned under state law (Chapter 30, of the Pa Public Utility Code) and TA-96.<sup>3</sup>

It is a privilege and an honor to be invited to present this testimony to the U.S. Senate Committee on Commerce, Science, and Transportation today.

### **I. Introduction: A Changed Paradigm**

During most of the 20<sup>th</sup> century, local telephone service has been treated as a natural monopoly. That paradigm changed in Pennsylvania in 1993, with the enactment of Chapter 30 of the Public Utility Code, *66 Pa.C.S. §§3001-3009*. Pursuant to Chapter 30 of the Code, *66 Pa.C.S. §3009*, the Commission approved four consolidated applications to provide competitive local exchange service *in Application of MFS Intelenet of Pa., et d., Docket No. A-310203F002, et al. (October 4, 1995)(MFS-I)*. These applications represented the first efforts at competition in the local exchange market for Pennsylvania since the first decades of the 20<sup>th</sup> century.

The national paradigm changed in 1996 with the enactment of the federal Telecommunications Act of 1996, *Pub. L. No. 104, 110 Stat.56, codified at 47U.S.C. §§151 et seq. (hereafter TA-96)*.

Pursuant to TA-96, Congress mandated the opening of local telecommunications markets to competition. Consequently, many proceedings — over 20 - were initiated before the Commission to bring competition to the local telecommunications markets in Pennsylvania including proceedings to

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<sup>2</sup> As of December 31, 1998, Verizon Pennsylvania (then known as Bell Atlantic Pennsylvania, Inc.) (VZ-PA) controlled a minimum of 90.6% of the business access lines and over 99% of residential access lines in its service territory. While the percentage of access lines that VZ-PA has declined over the last year, VZ-PA remains the monopoly service provider of all wholesale services that CLECs need in order to serve their customers.

<sup>3</sup> Global Order, P-00991648/P-001649.

address access charges, implicit subsidies in local exchange rates, and the maintenance of universal service.<sup>4</sup>

## **II. Realization that an Integrated Resolution of Local Competition Issues Was Required**

Due to the complexity of the various subject matters, the Pennsylvania Commission had proceeded to separately adjudicate individual telecommunications cases, with each case focused upon a particular aspect of local competition. This approach was the tried-and-true way that regulatory commissions historically have handled complex proceedings. However, the Commission realized that the telecommunications issues facing it were not only complex; they were inextricably intertwined. Resolution of one issue required consideration of many other local competition issues. The Commission also recognized that the pace of change in the industry and technology would outstrip the slow pace of piecemeal adjudication. The Commission therefore embarked on a comprehensive resolution, commonly known in Pennsylvania as the *Global* proceeding. The approach was not unprecedented in

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<sup>4</sup> [Application of MFS Intelenet of Pennsylvania, Inc. for Approval to Operate as a Local Exchange Telecommunications Company](#), A-310203F0002, P-00961137. [Application of MCI Metro Access Transmission Services, Inc for a Certificate of Public Convenience and Necessity to Provide and Resell Local Exchange Telecommunications Services in Pennsylvania](#), A-310236F0002. [Bell Atlantic-Pennsylvania, Inc. v. MCI Metro Access Transmission Services, Inc.](#), C-00967717, R-00973866C0001. [Formal Investigation to Examine and Establish Updated Universal Service Principles and Policies for Telecommunications in the Commonwealth](#), I-00940035. [Generic Investigation into Intrastate Access Charge Reform](#), I-00960066. [Investigation into Bell Atlantic-Pennsylvania's Entry into In-Region InterLATA Services under Section 271 of the Telecommunications Act of 1996](#), I-00980075, M-00960840. [Sen. Vincent J. Fumo Request for Declaratory and Injunctive Relief against Bell Atlantic for Violations of the Pennsylvania Telecommunications Act](#), I-00980080. [Formal Investigation to Examine and Establish Updated Universal Service Principles and Policies for Telecommunications Services in the Commonwealth](#), L-00950105. [Statement of Policy on Expanded Interconnection for Interstate Special Access](#), M-00920376. [Implementation of the Federal Telecommunications Act of 1996](#), M-00960799. [Petition of Bell Atlantic-Pennsylvania, Inc. for a Determination of Whether a Telecommunications Service is Competitive under Chapter 30 of the Public Utility Code](#), P-00971293. [Petition of Bell Atlantic-Pennsylvania, Inc. for a Generic Proceeding to Investigate Issuance of Local Telephone Numbers to Internet Service Providers by Competitive Local Exchange Carriers](#), P-00981404. [Pennsylvania Public Utility Commission v. The Bentleyville Telephone Company](#), R-00974174, R-00974174C0001, R-00974174C0002. [Pennsylvania Public Utility Commission v. Denver and Ephrata Telephone and Telegraph Company](#), R-00984315, R-00984315C0001.

Pennsylvania, and in fact had been used in the discussions that led to the legislation restructuring the electric industry, and in the individual company proceedings that followed.

### **III. Six months of Commissioner-Facilitated Settlement Discussions to reach a broad scale settlement**

In the fall of 1998 Chairman Quain and I issued an invitation to the parties to the numerous pending proceedings to join us in a global settlement conference for the purpose of exploring an integrated resolution of the complex issues presented by those proceedings, in an integrated conclusion. On March 1, 1999, the negotiation expired without resolution, but the negotiations did serve to focus the parties on potential integrated solutions. In addition, the discussions provided a much-needed opportunity to confer with the parties in a less formal atmosphere and served to provide us with a fundamental understanding of their business needs and concerns.<sup>5</sup>

### **IV. Six month of Focused Litigation**

Shortly after the *global* negotiations were concluded, two petitions were filed with the Commission proposing comprehensive solutions and recommending the closure of the pending dockets. The petitions were each sponsored by several participants in the prior negotiations and while each proposal addressed the same issues, the proposals clearly were incompatible. One Petition –docketed at P-00991648 and which became known as the 1648 petition was filed by three state senators, interexchange companies (IXCs) and competitive local exchange companies (CLECs). The other Petition—docketed at P-00991649 and which became known as the 1649 petition was filed on behalf of Verizon-Pennsylvania (VZ-PA), the rural telephone company coalition and two CLECs.

The Commission asked the parties to attempt to reach stipulations regarding issues that might reduce the necessity for prolonged hearings. This effort failed completely. All parties maintained that

their competing proposals were indivisible package deals. Consequently, the Commissioners unanimously decided to sit *en banc* during hearings and commenced formal litigation to develop an evidentiary record to enable them to decide the merits of each of the major issues of the numerous proceedings identified by the Commission. One of those issues, structural separation, is the focus of the balance of this testimony.

## V. Background of Pennsylvania Local Competition Laws

In Pennsylvania, VZ-PA was granted an alternative form of regulation pursuant to Chapter 30 in 1994.<sup>6</sup> Chapter 30 expressly anticipated that the alternative regulation of VZ-PA, as the dominant incumbent in the state, would facilitate competition in the local exchange market by requiring Verizon to provide cost-based, nondiscriminatory pricing and access to its network elements. See 66 Pa. C.S. §3009; MFS-I, et al. That did not happen, however, because VZ-PA had absolutely no incentives to open up its local exchange market to competitors. Even after the Telecommunications Act of 1996 was passed, the important policy objective in Pennsylvania and federal law, the promotion of local exchange competition, remained largely unsatisfied. Instead, VZ-PA still maintained a virtual monopoly in the Pennsylvania local exchange market. In addition, the evidence presented by VZ-PA's competitors in the *Global* proceeding, and in earlier proceedings incorporated into the pending docket, contained numerous examples of VZ-PA's abuse of its market power by providing competitors with less than

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<sup>5</sup> Legal waivers of due process concerns arising from the Pennsylvania statute governing *ex parte* communications were provided by the participating parties prior to the commencement of the settlement conferences.

<sup>6</sup> In re Bell Atlantic - Pennsylvania, Inc.'s Petition and Plan for Alternative Form of Regulation Under Chapter 30, Docket No. P-00930715 (Order entered June 28, 1994).

comparable access to its network, or by employing other discriminatory conduct that prevented VZ-PA customers from switching to a competitor<sup>7</sup>.

At the time of the *Global* decision, the Pennsylvania Commission was clearly frustrated, as were the FCC, other state commissions, and state and federal legislators, at the lack of progress in opening the local telecommunications markets to competition since the passage of TA-96 over three and one-half (3 1/2) years before<sup>8</sup> and the issuance of a Competitive (pricing) Safeguards Order<sup>9</sup> shortly thereafter. At the time of our decision, the FCC had rejected five (5) Section 271 applications and approved none. A good argument could be made that we were hardly closer to competition in the local exchange markets than we were in 1996. Some, like myself, had come to believe that the carrot of long distance entry might not have been sufficient inducement to open the local exchange market to competition. However, I also recognized that the responsibility to open the local markets to competition in Pennsylvania was an independent obligation and should not be conditioned on the success or failure of VZ-PA to gain entry into the long distance market.

## **VI. The Commission's Decision to Require Separation of VZ-PA's Wholesale/Retail Operation<sup>10</sup>**

The 1648 and 1649 Petitions each acknowledged the serious conflict of interest and opportunity for anti-competitive conduct by an incumbent local exchange carrier that provides both retail services directly to local service customers and wholesale services to other telecommunications

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<sup>7</sup> See, e.g., MCI WorldCom Statement No. 4.0, at 23-30 (various examples provided); Covad Statement No. 2, at 4-10 (Covad witness describes collocation experience in Pennsylvania with BA-PA); AT&T Statement No. 3.0, at 13-24 (AT&T witness similarly describes collocation experience in Pennsylvania with BA-PA); Petition of Bell Atlantic Pennsylvania, Inc. for a Determination that Provision of Business Telecommunications Services is a Competitive Service under Chapter 30 of the Public Utility Code, Docket No. P-00971307, Recommended Decision of ALJ Michael Schnierle at 46 (July 24, 1998) (litany of CLEC complaints arising from BA-PA's OSS cited to by Judge Schnierle; Docket No. P-00971307).

<sup>8</sup> Opinion and Order, of the Pennsylvania Public Utility Commission, P-00991648/P-001649, page 228.

<sup>9</sup> Opinion and Order, of the Pennsylvania Public Utility Commission, M-00940587, entered August 6, 1996.

carriers competing for those same local service customers. Accordingly, both petitions proposed a "Code of Conduct" setting forth rules to ensure fair and nondiscriminatory treatment of telecommunications carriers when they seek to purchase wholesale services from an ILEC in order to provide retail services to end-users in competition with the ILEC.

A very significant difference between the two proposals was in the type of business unit separation requirement recommended for preventing VZ-PA from receiving any unfair competitive advantage in the marketplace. The 1649 Petition's Code of Conduct proposed a functionally separate organization for its wholesale services, such as an operating division within the existing corporate entity that would service the wholesale clients, as adequate protection to ensure nondiscriminatory access to VZ-PA's wholesale services by competing telecommunications carriers. The 1648 Petition, on the other hand advocated a structural separation of the wholesale and retail arms of BA-PA into two distinct corporate subsidiaries such that the wholesale subsidiary would service its retail affiliate and competitors alike.

Based on the record, the Commission concluded that structural separation is the most efficient tool to ensure local telephone competition where a large incumbent monopoly controls the market. VZ-PA controlled the vast majority local exchange access lines in its service territory and controlled bottleneck facilities in most, if not virtually all, local exchange markets where it operated. This overwhelming competitive presence, the concomitant ability to exercise market power; the ability to provide itself with anti-competitive cross-subsidies, and the opportunity and incentive to discriminate against competing telecommunications carriers in the provision of wholesale services strongly support the Commission's conclusion, that structural separation is necessary to provide the local service competition envisioned under Pennsylvania law (Chapter 30) and TA-96.

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<sup>10</sup> A copy of this section of the Order is appended to the testimony. The text of the full Order can be found on the web site of the Pa PUC at <http://puc.paonline.com>.

TA-96 and Pennsylvania's own statutory mandate under Chapter 30, have as goals the provision of competitive services by alternative providers on equal and non-discriminatory terms. 47 U.S.C. §§251 and 271; 66 Pa.C.S.§3001. Both legislative mandates envision a telecommunications arena where competition creates savings and technological innovations for our nation and Pennsylvania. Both statutes recognize and authorize structural separation as a regulatory tool to implement a competitive market where unfair competition may result absent its implementation. 47 U.S.C. §272; 66 Pa. C.S. §3005(h).<sup>11</sup>

The Commission found that it could not exercise its duty to enforce, execute, and carry out the pro-competitive mandates of Chapter 30 absent structural separation<sup>12</sup>. It also found that given the length of time needed to actually accomplish structural separation for VZ-PA (estimated at the time to require approximately one year), it would be inefficient and more burdensome for VZ-PA to require separate retail affiliates on a piecemeal basis as different parts of the local service market are declared competitive. The Commission expected that if it ordered the structural separation planning, hearing, and implementation process to begin, it could be accomplished within the approximate time frame that VZ-PA was expected to achieve Section 271 approval from the FCC and formal designation of its remaining retail services as competitive from Pennsylvania. A proceeding to implement the details of

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<sup>11</sup> Section 3005(h) specifically provides for the use of structural separation as a regulatory tool for LECs serving over one million access lines "if the commission finds that there is a substantial possibility that the [competitive] service on a non-separated basis will result in unfair competition". Section 3005(h) was clearly applicable because the ultimate goal of the proceeding was to open up competition in all telecommunications markets in Pennsylvania, especially local competition. In addition, the proceeding established a process that could lead to a formal declaration that all remaining retail local services are "competitive" under Chapter 30. Moreover, the fact that the Commission addressed this matter in a 1994 proceeding under Chapter 30, well in advance of the enactment of TA-96, did not preclude the Commission from imposing structural separation based on the record of the current proceeding.

<sup>12</sup> ". . . , *we cannot fulfill our Section 501 duty* to enforce, execute and carry out our mandate under Chapter 30 to promote and encourage the provision of competitive services on equal terms throughout the Commonwealth" [absent structural separations]. (p. 224)

structural separation was convened following the *Global Order*. I'll address that proceeding later in this Statement

The Pennsylvania Commission's structural separation decision was a sound exercise of its administrative discretion and application of law, based on the overwhelming record evidence that had been amassed. The decision also built upon its experience in designing and implementing the most successful competitive electric model in the country.<sup>13</sup> Structural separation for the dominant service provider, faced with an inherent incentive to discriminate against its competitors in order to preserve or expand its own market share, represented the only rational choice to compel VZ-PA to comply with the non-discrimination provisions of state law and federal law in Pennsylvania. The Commission also found in the *Global Proceeding* that the non-structural remedy proposed by VZ-PA would be less effective in preventing market power abuses and more costly to enforce. We also took administrative notice that structural separation had been successfully implemented by other states in the telecommunications and gas industries<sup>14</sup>.

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<sup>13</sup> See, e.g. Application of PECO Energy Company for approval of its restructuring Plan Under Section 2806 of the Public Utility Code and Joint Petition for Partial Settlement, Docket Nos. R-00973953 and P-00971265 (Order entered December 23, 1997) (PECO Restructuring Order). In the PECO Restructuring case the Commission found that:

Functional separation of regulated [electric distribution company] functions and competitive generation functions is essential for the development of a vibrant competitive market. Structural separation through the establishment of fully independent entities is preferable whenever possible.

Id. at 128.

Structural separation is not the wildly expensive draconian bloodletting of a regulatory agency run amok that VZ-PA depicted to the Pennsylvania legislature and the courts. Unlike divestiture, which is used to remedy anti-competitive behavior and which requires certain lines of business to be sold, structural separation is a less sweeping vaccination which leaves the company free to engage in the activity at issue.

The structural requirement levels the ‘regulatory parity’ field. It also changes the regulatory oversight responsibilities, hopefully in ways that better suit regulatory staff skill sets and makes parity of reporting treatment more realistic.

Separate subsidiaries enable regulators to view the terms of affiliate transactions in ways that facilitate detection of an affiliate receiving favored treatment due to the contractual nature of the transactions. Structural separation heightens both the likelihood and perception of fairness and if carried out hopefully will enhance the willingness of potential competitors to make the investment to enter a market in the face of an overwhelming competitor that controls essential bottleneck facilities.

## **VII. The Inevitable Appeal**

While the Commission’s decision to order structural separations was final, the details remained to be worked out. VZ-PA undertook extraordinary appellate efforts to request the Pennsylvania Supreme Court to immediately assume fast-tracked jurisdiction of the appeal. Its effort proved unsuccessful and typical appellate procedures ensued. VZ-PA filed state and federal appeals of the Commission’s decision. Front and center was the structural separations decision, along with various and sundry challenges to other portions of the *Global Order*.

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<sup>14</sup> See AT&T Statement No. 1, at 24-26; Senators’ Statement No. 1, at 28, 30-32; Main Brief of AT&T at 85-87; Initial Brief of Senators Madigan, Fumo, and White at 53-57. See also Robert E. Burns et al., *Market Analysis of Public Utilities: The Now and Future Role of State Commissions* at 6 (National Regulatory Research Institute July 1999) (study recommends that state regulatory commissions should consider structural separation as a regulatory tool to offset potential cross-subsidization problems, especially where utility services are being provided in markets that are initially highly concentrated).

VZ-PA also initiated appeals of the *Global Order* in the lower appellate court, Pennsylvania Commonwealth Court, as well as in the U.S. District Court, Eastern District of Pennsylvania. The Pennsylvania Commonwealth Court unanimously upheld the PUC's Decision on all issues and in particular the structural separation decision. Bell Atlantic-Pennsylvania, Inc. v. Pa. PUC, Nos. 2790 C.D. 1999 et seq., (October 25, 2000). The Court found that the PUC had the authority under federal and state law to order structural separations (47 U.S.C. Sections 253(b), 272, 261(c)), and that the PUC's evidentiary record constituted "substantial evidence." Subsequent events, which will be explained in Section IX, have mooted further state appeals challenging the PUC's authority to impose structural separations.

I find the similarities between the Pennsylvania Commonwealth Court Opinion and a subsequent Order of the United States Court of Appeals for the Sixth Circuit, to be compelling! The Sixth Circuit focused on the decision of the FCC to impose structural separation on all local telephone companies providing commercial mobile radio service. GTE Midwest, Inc. et. al. V. Federal Communications Commission, Nos. 98-3167/3203, 2000 FED App. 0392P (6<sup>th</sup> Cir.) (November 15, 2000).

The FCC argued:

- a. The LECs have the incentive and opportunity to engage in anti-competitive practices.
- b. Increased competition may increase the incentive to discriminate against competitors requesting interconnection.
- c. The costs of the separate subsidiary implementation do not outweigh the benefits.
- d. It is not a requirement without precedent.

The Petitioners argued:

- a. The requirement was contrary to the Congressional intent underlying the Telecommunications Act of 1996;
- b. Congress had the opportunity to impose structural separation and declined by classifying wireless services as “incidental interLATA” services, which are exempt from the separate affiliate requirement;
- c. Section 601(a)(3) of the Act released AT&T from the requirement that it provide its cellular service through a separate affiliate;
- d. Congress sought to promote parity between AT&T and the Bell companies and did not intend for the Commission to have the power to declare a new separate affiliate requirement.

The Court affirmed the FCC decision, as a legitimate exercise of the agency’s expertise and as a matter of federal law, finding:

- a. That the FCC reasonably concluded that it could not rely exclusively on non-structural safeguards given the monopoly power of the LECs that stems from the bottleneck control over the infrastructure;
- b. The Court expressly declined to second-guess the expert choice of the FCC on this point, and did not require the FCC to point to specific instances of past abuse to justify its decision;
- c. The Act does not limit the FCC’s authority to adopt separate affiliate requirements, citing Section 601(c)(1);
- d. There is no explicit indication that the Act is intended to promote regulatory parity between non-dominant carriers such as AT&T and dominant carriers such as the Bell companies;
- e. If Congress had sought to preclude the FCC’s ability to impose separate subsidiary requirements, it could have done so explicitly.

### **VIII. Structural Separations Provides a Preferred Means of Enforcing Competition-Opening Legal Requirements.**

In my opinion, structural separation provides a bright-line demarcation point between the retail and wholesale activities of the incumbent, and coupled with an appropriate code of conduct, prescribes a clear framework for requiring arms length dealings with the incumbent's retail affiliate. The wholesale affiliate must treat its retail affiliate in the same manner that unaffiliated competitors interact with the wholesale company. Under Pennsylvania law, the retail and wholesale affiliate transactions and services would have to be memorialized in a written agreement that would be subject to regulatory scrutiny before the fact under the affiliated interest provisions of the PA Public Utility Code, 66 Pa. C.S.A. §2100, *et seq.* The Commission has the built-in mechanism for exercising forward-looking regulatory responsibility. While ongoing oversight of these contractual requirements would be required, the structurally separate relationship of these entities would make it much easier to police and oversee. Detection of contract violations and Commission Orders would be more consistent with the training and practice of commission staff. Violations if detected could result in voiding business transactions and could be determined to be unlawful activity.

Structural separation avoids the detailed, ongoing, enforcement responsibilities that functional separations demands. Joel Klein, formerly of the U.S. Department of Justice, captured the assessment of the situation with the following observation:

Finally, based on a century of experience, I would further emphasize that the Department [Department of Justice] is also highly skeptical of any relief that requires judges or regulators to take on the role of constantly policing the industry. Relief generally should eliminate the incentive or the opportunity to act anticompetitively rather than attempt to control conduct directly. We are institutionally skeptical about code-of-conduct remedies. The cost of enforcement are high and, in our experience, the regulatory agency often ends up playing catch-up, while the market forces move forward and the underlying competitive problems escape real detection and remediation, (*Making the Transition form Regulation to Competition*, FERC Distinguished Speaker Series, January 21, 1998, p.12)

### **IX. The Structural Separation Implementation Proceeding**

True to its word, the PUC initiated a separate proceeding to implement the structural separation decisions that it reached as part of the *Global Order*. The parties' arguments were predictable: VZ-PA complained that structural separation was inefficient and costly while CLECs set forth various alternatives to accomplish the PUC's decision. The proceeding turned on whether VZ-PA would be permitted to bundle its retail and wholesale services together and whether the retail and wholesale companies must abide by a true, arms length relationship, to be prescribed in a stringent Code of Conduct. VZ-PA mainly relied on the Verizon Advanced Data Services affiliate that it set up in compliance with one of the merger conditions to which Verizon had agreed as part of obtaining the FCC's approval of the Bell-GTE merger. CLECs objected, contending that wholesale and retail services must be uncoupled from its current intertwined relationship.

The PUC decided in March, and issued an Order in April, to require VZ-PA to undertake a "functional/structural separation" and to agree to other market-opening conditions. If VZ-PA refused the conditions, then the PUC advised that it would issue another order calling for structural separation. VZ-PA did subsequently accept the PUC's conditions. The PUC claimed that the "expeditious implementation" of functional separation would be more worthwhile than compelling structural separation followed by the inevitable litigation and regulatory micro-management stemming from structural separations.

In my view, the Commission has substantially abandoned the concept of regulatory efficiency, failed to appreciate that the implementation of its current plan will not be expeditious, condemned itself to ongoing regulatory oversight for which it is poorly equipped and will not avoid protracted litigation. In summary the PUC replaced the structural separation directive with the following provisions.

1. VZ-PA is required to establish non-structural safeguards, such as separate accounting for wholesale and retail services and abide by a code of conduct that requires VZ-PA to treat competitors in a nondiscriminatory manner.
2. The separation of wholesale and retail divisions must be accomplished through a new Code of Conduct and competitive safeguards, that will be established in a separate rulemaking proceeding. The New Code of Conduct shall encompass personnel, accounting, record keeping and business practices. In the meantime, VZ-PA is supposed to comply with the Interim Code of Conduct established in the *Global Order*.
3. Although already accomplished, consistent with its commitment to the FCC in the Bell-GTE merger, VZ-PA must establish an advanced services affiliate.
4. Verizon's advanced data services affiliate must comply with the Section 251 unbundling, interconnection and resale obligations.
5. Several industry collaboratives concerning pending technical issues regarding loop provisioning were convened.
  - a. Industry standards for providing CLECs with access to equipment known as "DSLAMs" in remote terminals that may enable them to provide DSL service over copper lines will be discussed through an industry collaborative.
  - b. VZ-PA must commence a trial of electronic loop provisioning to determine its feasibility.
  - c. Next Generation Digital Line Carrier and equal access to DSL over fiber will be discussed through an industry collaborative.
  - d. A line-splitting collaborative was established.
6. VZ-PA must withdraw all appeals that challenge the PUC's *Global Order*. VZ-PA must agree to increase remedy payments for providing CLECs with discriminatory service. For violations of performance standards up to 30 days, VZ-PA must pay \$3,000 to each affected CLEC. For violations

that occur from the 31<sup>st</sup> day to the 90<sup>th</sup> day, VZ-PA must pay \$5,000 to each affected CLEC. The PUC also initiated another new proceeding to determine whether any further adjustments of these payments should be made.

VZ-PA must reduce (by 75 cents) the loop rate in the rural areas of VZ-PA's territory known as Density Cell 4. The PUC convened another separate proceeding to address whether any further UNE rate adjustments should be ordered.

As part of its March 22, 2001, deliberations, two of the Commissioners made clear that they were extremely displeased with the manner in which VZ-PA had conducted its publicity campaign concerning the regulatory issues at stake in the proceeding. Outgoing Chairman Quain requested the PUC prosecutory staff to initiate an Order to Show Cause against VZ-PA for engaging in an "extensive, systematic campaign of misinformation" that was "based on exaggerated fears rather than the facts."

In response to Petitions filed by AT&T and Sprint to clarify the April Order, the PUC issued a subsequent Order in May, 2001. The May 2001 Order referred allegations to the Commission's Law Bureau for review and potential initiation of an action against VZ-PA for failing to comply with the *Global Order Interim Code of Conduct* from September 1999 through April 2001, the period following the *Global Order* through the issuance of the April 2001 Structural Separations Order. As for considering the adoption of an Interim plan for functional/structural separation, the PUC declined to adopt one and instead directed VZ-PA to submit a report by July 23, 2001, detailing the interim compliance with the PUC's April 2001 Order.

#### **X. A Regulatory Mandate rather than a Utility-Sponsored "Voluntary" Initiative**

Structural separation may be painful to implement, at the beginning, but more cost effective and efficient over time. There is no question that structural separation would have imposed additional costs on VZ-PA-Retail; but no one at the Commission has suggested that those costs are not recoverable from the clients of the wholesale subsidiary, competitors and affiliates alike. Those costs are, in my

opinion, a reality of the transition to non-discriminatory access to the incumbent network. One of the fundamental tradeoffs in converting from a monopoly to a competitive market is the potential for duplicative capacity and higher operating costs in the immediate term, in exchange for innovation and managerial changes that improve productivity and thus lower costs over the long term.

The fact that VZ-PA continues to argue that forcing its retail operations to function similar to all other CLECs is “inefficient” and “imposes additional costs on its customers”, demonstrates very clearly that the two functional divisions (one for itself and another for competitors) that it proposed to handle wholesale customers, are not equal.

#### **XI. How would I define a successful structural separation regime?**

A successful structural separation would accomplish each of the points that I have identified in my testimony and which were identified by the Commission when it initially directed the structural separation of Verizon-PA. It would:

- Ensure non-discriminatory access to interconnection, resale, UNEs and OSS.
- Benefit ratepayers with lower overall cost of service.
- Result in improved ILEC wholesale performance to CLECs as a general matter (i.e. improved OSS interfaces, arms length transactions).
- Reduce regulatory oversight and the resources needed by the regulator for monitoring and enforcement.

#### **XII. If Structural Separations Is Such A Crazy Idea, Then Why Have Some Companies Voluntarily Embraced It As Part Of Their Business Plans?**

In April, 2000, British Telecom (BT) announced plans to separate its wholesale and retail businesses, creating a new network company, NetCo., which would be both structurally and managerially separate. BT said that the move is pro-competitive and removes any perceived conflicts between NetCo and the rest of BT. The new NetCo will be able to focus solely on meeting the needs

of the other licensed operators and service providers including of course, BT-Retail and the retail operators will all benefit from being served by a company that has a clear, separate and exclusive emphasis on their distinct needs. In the view of BT (Nov. 9, 2000), the creation of NetCo (a fully separate company) should reduce the need for those aspects of regulation which derive from its current vertically integrated structure. Sir Ian Vallance, BT's chairman, expected NetCo to be up and running during 2001, assuming shareholder approval and the Annual shareholder General Meeting in July 2001.

Regulation of BT in the UK will have greater clarity and should be concentrated primarily on the wholesale business. An immediate advantage of the restructuring is that in identifying the separate businesses within BT, shareholders and analysts will be able to gain a greater understanding of their intrinsic value and potential. This in turn will facilitate separate stock listings for some of BT's businesses.

The new businesses would trade on an arm's length basis with each other. This would allow regulation to be concentrated primarily on the wholesale business, which will supply services to other operators and service providers as well as the BT retail operation. This change should enable the BT retail operation to be increasingly treated in the same way as other companies in the competitive market by its regulators.

### **XIII. CONCLUSION:**

The Pennsylvania Commission found that it could not exercise its duty to enforce, execute, and carry out pro-competitive mandates absent structural separation. It also found that it would be inefficient and more burdensome on VZ-PA to require separate retail affiliates on a piecemeal basis, as different parts of the local service market are declared competitive.

The Commission's decision to require structural separation of wholesale and retail functions was logical, and built on its experience in designing and implementing the most successful competitive electric model in the country. Structural separation, for the dominant service provider, steeped in

embedded subsidies and support mechanisms, represented the only rational approach of record for administering the non-discrimination provisions of state law and federal law in Pennsylvania.

Unlike divestiture, which is used to remedy anti-competitive behavior and which requires certain lines of business to be sold, structural separation is a less sweeping vaccination against anti-competitive and discriminatory behavior. Structural separation is not the wildly expensive, draconian bloodletting, of a regulatory agency run amok, that VZ-PA depicted to the public, the legislature and the courts.

A structural separation requirement changes the regulatory oversight responsibilities, hopefully in ways that better suit regulatory staff skill sets and makes parity of reporting requirements more realistic among competitors.

Separate subsidiaries enable regulators to view the terms of affiliate transactions in ways that can easily discern that an affiliate is not receiving favored treatment. It heightens both the likelihood and perception of fairness and, when implemented, would hopefully enhance the willingness of potential competitors to make the investment to enter a market where a competitor continues to control essential bottleneck facilities.

Thank you very much for the opportunity to present my perspectives on this issue to you.

## Executive Summary

Structural Separation is the most effective tool to ensure local telephone competition

### Why?

- Chapter 30 expressly anticipated that the alternative regulation of VZ-PA would be accompanied by competition in the local exchange market – It did not happen.
- The record contained numerous examples of VZ-PA abuse of market power.
- The Commission found itself unable to enforce-execute-carryout pro-competitive mandates.
- Structural separation would reduce the level of oversight resources required to monitor deregulated retail operations.
- Non-structural separation would require continuing regulatory oversight.
- Violations would be more difficult to detect without structural separations.
- Non-structural separations would be more costly to enforce.
- Structural separation is consistent with the successful electric restructuring experience.
- Oversight responsibilities are more consistent with traditional staff skills and training.
- The Commission was presented with a choice between functional organization and structural separation.
- VZ-PA controlled over 90% of the local exchange access lines in its territory.
- VZ-PA controlled bottleneck facilities in most if not all local exchange markets where it operated.
- VZ-PA is an overwhelming competitive presence.
- VZ-PA has the ability and used that ability to exercise market power.
- VZ-PA has the ability and used that ability to cross subsidize its competitive services.
- VZ-PA has the opportunity and incentive to discriminate, and in fact discriminated against competitors.

### Under what conditions?

- A large incumbent controls 90+% of the local exchange access lines.
- The incumbent controls bottleneck facilities in most (virtually all) of the local exchange markets where it operates.
- The incumbent has an overwhelming competitive presence.
- The incumbent has the ability to exercise market power.
- The incumbent has the ability to provide itself anti-competitive cross subsidies.
- The incumbent has the opportunity and incentive to discriminate.

