TAXPAYER EXHIBIT
B1
September 20, 2011
Pacific Bell Telephone and Affiliates
521312

# Appeal of Pacific Bell Telephone Company and Affiliates

## Case ID No.: 521312

### Exhibits for Oral Hearing
### September 20, 2011

1

# *Functional Test under Hoechst Celanese*

"The property must be so **interwoven into the fabric** of the taxpayer's business operations that it becomes **'indivisible'** or **inseparable** from the taxpayer's business activities with **both 'giving value' to each other** . . . . Such a relationship exists when the taxpayer controls and uses the property to contribute materially to the taxpayer's production of business income." (emphasis added)

*Hoechst Celanese Corp. v. FTB* (2001) 25 Cal. 4th 508, 532

2

***Appeal of Occidental Petroleum Corporation, 83-SBE-119, June 21, 1983***

"At no time did [the minority interests] possess more than the potential for actual integration into appellant's ongoing business, and we believe that **mere potential is insufficient** to support a finding that that gains on these sales were business income under the functional test."

(cited with approval in *Appeal of Mark Controls*, 86-SBE-204, December 3, 1986.)

3

# SBC's 2001-2002 Foreign Investments Summary

| | Name of Investment | Year of Acquisition | Location | Business | Disposition Date | 2001-2002 Interest | Majority owner | Number of SBC Directors | Number of SBC expats during 2001-2002 | Number of Employees of the Investments |
|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Amdocs | 1985 | Israel | software | N/A | 10% | Public | 1 of 11 | 0 | 9,000 |
| 2 | Telmex | 1990 | Mexico | primarily wireline | N/A | 7.6 - 8.1% | Grupo Carso | 4 of 17 | 16 | 63,755 |
| 3 | TransAsia | 1997 | Taiwan | wireless | 2001 | 43.6% | Asia Pacific Investment Co. | 3 | 2 | N/A |
| 4 | diAx | 1998 | Switzerland | wireless | 2001 | 40% | diAx holding (consortium of Swiss utilities) | 3 of 7 | 12 | N/A |
| 5 | Belgacom (Ameritech) | 1999* | Belgium | wireline and wireless | 2004 | 17.5% | Belgian government | 3 of 18 | 17 | 23,314 |
| 6 | Tele Danmark (Ameritech) | 1999* | Denmark | wireline and wireless | 2004 | 41.6% | Public | 5 of 12[a] | 3 | 22,263 - 22,485 |
| 7 | Bell Canada (Ameritech) | 1999* | Canada | wireline and wireless | 2002 & 2003 | 20% | Bell Canada Enterprises (BCE) | 2 of 10 | 7 | 66,266 - 75,000 |

* Originally Ameritech (AIT) investments that SBC acquired through a merger with AIT in 1999. AIT acquired its interest in Belgacom in 1995 through an investment consortium called ADSB; Tele Danmark in 1998; and Bell Canada in 1999.

[a] Although SBC could vote for 6 of the 12 directors, including the Chairman, Danish law required the Chairman of the Board to be a Danish citizen. The Chairman was independent from SBC.

10-K 1 form10k.htm SBC COMMUNICATIONS 2001 FORM 10-K

FTB

EXHIBIT A

**FORM 10-K**

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(Mark One)

|X| **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For fiscal year ended December 31, 2001**

**OR**

|_| **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from__________to**

Commission File Number: 1-8610

**SBC COMMUNICATIONS INC.**

Incorporated under the laws of the State of Delaware
I.R.S. Employer Identification Number 43-1301883

175 E. Houston, San Antonio, Texas 78205-2233
Telephone Number 210-821-4105

Securities registered pursuant to Section 12(b) of the Act: (See attached Schedule A)

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes_X_ No ___

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. (X)

Based on composite closing sales price of $37.45 per share on January 31, 2002, the aggregate market value of all voting and non-voting stock held by non-affiliates was $125,494,192,498.

As of January 31, 2002, 3,352,019,692 shares of Common Stock were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

(1) Portions of SBC Communications Inc.'s Annual Report to Shareowners for the fiscal year ended December 31, 2001 (Parts I and II).

(2) Portions of SBC Communications Inc.'s Notice of 2002 Annual Meeting and Proxy Statement dated on or about March 11, 2002 (Parts III and IV).

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## SCHEDULE A

Securities Registered Pursuant To Section 12(b) Of The Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Shares (Par Value $1.00 Per Share) | New York, Chicago and Pacific Stock Exchanges |
| 6.875% Fifty Year Southwestern Bell Telephone Company Debentures, Due March 31, 2048 | New York Stock Exchange |
| 7.00% Forty Year SBC Communications Inc. Notes, Due June 13, 2041 | New York Stock Exchange |

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## TABLE OF CONTENTS

## PART I

### ITEM 1. BUSINESS

## GENERAL

SBC Communications Inc. (SBC) is a holding company incorporated under the laws of the State of Delaware in 1983 and has its principal executive offices at 175 E. Houston, San Antonio, Texas 78205-2233 (telephone number 210-821-4105). SBC maintains an Internet site at http://www.sbc.com. (This web site address is for information only and is not intended to be an active link or to incorporate any web site information into this document.)

Throughout this document SBC is referred to as "we" or "SBC".

**History**

SBC was formed as one of several regional holding companies created to hold AT&T Corp.'s (AT&T) local telephone companies. On January 1, 1984, SBC was spun-off from AT&T pursuant to an anti-trust consent decree, becoming an independent publicly traded telecommunications services provider. At formation, we primarily operated in five southwestern states. SBC subsidiaries merged with Pacific Telesis Group (PAC) in 1997, Southern New England Telecommunications Corporation (SNET) in 1998 and Ameritech Corporation (Ameritech) in 1999, thereby expanding our wireline operations as the incumbent local exchange carrier into a total of 13 states. Our services and products are marketed under several brands including SBC Ameritech, SBC Nevada Bell, SBC Pacific Bell, SBC SNET, SBC Southwestern Bell, and, through our joint venture with BellSouth Corporation (BellSouth), Cingular Wireless (Cingular).

**Scope**

We rank among the largest providers of telecommunications services in the United States and the world. Through our subsidiaries, we provide communications services and products in the United States and have investments in more than 25 countries. We offer our services and products to businesses and consumers, as well as other providers of telecommunications services.

The services and products that we offer vary by market, and include: local exchange services, wireless communications, long distance services, Internet services, telecommunications equipment, messaging, paging, and directory advertising and publishing. We group our operating subsidiaries as follows, corresponding to our operating segments for financial reporting purposes:

- wireline subsidiaries provide primarily land and wire based services,
- wireless subsidiaries hold our investment in Cingular, which provides primarily radio wave based services,
- directory subsidiaries provide services related to directory advertising and publishing,
- international subsidiaries hold investments in primarily foreign entities outside of the United States, and
- other subsidiaries provide corporate operations, paging and prior to 2001, primarily provided security monitoring and cable television services.

Our principal wireline subsidiaries provide telecommunications services in thirteen states: California, Texas, Illinois, Michigan, Ohio, Missouri, Connecticut, Indiana, Wisconsin, Oklahoma, Kansas, Arkansas and Nevada (13-state area). Certain wireline local exchange services offered in the 13-state area are provided through regulated subsidiaries which operate within authorized regions (in-region) subject to regulation by each state in which they operate and by the Federal Communications Commission (FCC). Additional information relating to regulation is contained under the heading "Government Regulation" below and in the 2001 SBC Annual Report to Shareowners under the heading "Operating Environment and Trends of the Business", and is incorporated herein by reference pursuant to General Instruction G(2).

*InterLATA Long Distance*

We offer interLATA (Local Access and Transport Area) long distance services in the states of Texas, Kansas, Oklahoma, Arkansas, Missouri and Connecticut. We intend to seek approval from the FCC to offer interLATA long distance in our other in-region states. As a first step in that process, we have filed applications with the state commissions in California, Illinois, Michigan, Nevada and Ohio.

Additional information on InterLATA Long Distance is contained in the 2001 SBC Annual Report to Shareowners under the heading "Long Distance" on page 14 which is incorporated herein by reference pursuant to General Instruction G(2).

*Broadband Initiative*

In 1999, as the first post-Ameritech merger initiative, we announced a $6 billion initiative to provide broadband services (Project Pronto). Project Pronto is expected to create a broadband platform that will allow high-speed voice, data and video services to be provided via Digital Subscriber Line (DSL) services to approximately 80 percent of our United States (U.S.) wireline customers. During the third quarter of 2001, due primarily to an adverse and uncertain regulatory environment, we began a slowdown of the capital expenditures to build our national broadband network, which includes fiber, electronic and other technology. As of December 31, 2001 we had spent $3.2 billion on Project Pronto and had 1.3 million DSL subscribers with more than half, or 25 million, of our wireline customers DSL-capable.

Additional information on Project Pronto is contained in the 2001 SBC Annual Report to Shareowners under the heading "Data/Broadband" on page 14 which is incorporated herein by reference pursuant to General Instruction G(2).

*National Expansion*

In 1999, we began implementation of a "National-Local" strategy in conjunction with our acquisition of Ameritech. We planned to offer local exchange services in 30 new markets across the country. In March 2001, we announced a scale-back of our offerings while still satisfying our regulatory obligations. We offered services in 22 markets as of December 31, 2001, and are required by the FCC to enter into the remaining eight markets by April 2002.

Additional information on National Expansion is contained in the 2001 SBC Annual Report to Shareowners under the heading "Out-of-Region Competition" on page 17 which is incorporated herein by reference pursuant to General Instruction G(2).

**Business Combinations**

SBC subsidiaries merged with Ameritech in 1999, SNET in 1998 and PAC in 1997, resulting in each acquired company becoming a wholly owned subsidiary of SBC. Each transaction has been accounted for as a pooling of interests and a tax-free reorganization.

As a result of the Ameritech, SNET and PAC mergers, we significantly integrated operations and consolidated some administrative and support functions. We recognized charges during 1999, 1998 and 1997 in connection with these merger initiatives. Charges arising out of the mergers relating to relocation, retraining and other effects of consolidating certain operations were recognized in the periods those charges occurred.

Additional information on business combinations is contained in Note 2 of the 2001 SBC Annual Report to Shareowners and is incorporated herein by reference pursuant to General Instruction G(2).

## BUSINESS OPERATIONS

**Operating Segments**

Our segments are strategic business units that offer different products and services and are managed accordingly. We evaluate performance based on income before income taxes adjusted for normalizing (e.g., one-time) items. We have five reportable segments that reflect the current management of our business: (1) wireline; (2) wireless; (3) directory; (4) international; and (5) other.

In the second quarter of 2001, we moved the results of the SBC Services unit from the other segment to the wireline segment as the SBC Services unit primarily supports the wireline segment. We have restated all prior period information for the change, and this had no effect on our consolidated results.

Additional information about our reportable segments, including financial information and normalizing items, is included under the heading "Segment Results" on pages 7 through 13 and in Note 5 of the 2001 SBC Annual Report to Shareowners and is incorporated herein by reference pursuant to General Instruction G(2).

**Wireline**

Wireline is our largest operating segment, providing approximately 75 percent of our normalized operating revenues in 2001. Our wireline segment operates as both a retail and wholesale seller of communication services. We provide landline telecommunications services, including local, network access, long distance services, messaging, Internet services, and customer premises and private branch exchange (PBX) equipment. Our landline telecommunications subsidiaries serve approximately 35.0 million residential, 23.9 million business and 0.5 million other access lines in our 13-state area.

***Services and Products***

**Local exchange services** - Local exchange services include traditional dial tone primarily used to make or receive voice, fax, or analog modem calls from a residence or business. We also offer this service on a wholesale basis to competitors. At December 31, 2001, we provided wholesale services to approximately 3.6 million access lines. Other local services include certain extended area service, directory assistance and operator services.

Vertical services include custom calling services such as Caller ID, Call Waiting, voice mail and other enhanced services. These features allow telephone users to manage their local services with enhanced features such as displaying the number and/or name of callers, signaling to the telephone user that additional calls are incoming, and sending and receiving voice messages. These services are not regulated by the FCC and are generally more profitable.

**Data services** - Revenues from data services may be classified as local, network access or long distance revenues and include high-speed data communication services used for transporting digital traffic from one computer system to another. Data services include digital products categorized into three basic categories:

- Switched Transport services such as Integrated Services Digital Network (ISDN), Frame Relay, and DSL;
- Dedicated Transport services such as Digital Services and Synchronous Optical Network (SONET); and
- Application and Data Communications services which include Internet access and network integration.

ISDN transmits voice, video, and data over a single line in support of a wide range of applications, including Internet access. Frame Relay is a fast packet switching technology that allows data to travel in individual packets, or pieces, of information. DSL is a digital modem technology that converts existing twisted-pair telephone lines into access paths for multimedia and high-speed data communications to the Internet or private networks. DSL allows customers to simultaneously make a phone call and access information via the Internet or an office local area network. Digital Services are high-speed dedicated digital circuits offered with various speeds of transport. SONET provides customer access to our backbone network at very high speeds. Network integration services include installation of business data systems, local area networking, and other data networking solutions.

**Network access services** - Network access services connect a customer's telephone or other equipment to the transmission facilities of other carriers that provide long distance and other communications services.

**Wireline long distance** - Wireline long distance services primarily result from the transport of intraLATA telecommunications traffic that is outside of a local calling area. Federal regulation prohibits us from providing interLATA long distance services in seven of our 13 in-region states. We provide wireline interLATA long distance to our customers in Texas, Kansas, Oklahoma, Arkansas, Missouri and Connecticut. Long distance services also include other services such as Wide Area Telecommunications Service (WATS or 800 services) and other special services. In addition, since 1996, we have offered wireline interLATA long distance services to customers in selected areas outside the wireline subsidiaries' authorized regions.

**Customer premises equipment (CPE)** - CPE and other equipment sales range from single-line and cordless telephones to sophisticated digital PBX systems. PBX is a private telephone switching system, usually located on a customer's premises, which provides intra-premise telephone services as well as access to the public switched network.

**Internet Services** - We offer a range of Internet services and products for residences and businesses, varying by market.

Internet services offered include basic dial-up access service, dedicated access, web hosting, e-mail, and high-speed access services. During 2000, we formed a relationship with Prodigy Communications Corporation (Prodigy) that combined our residential and small business Internet operations. In the fourth quarter of 2001, we acquired Prodigy.

Additional financial information on the Prodigy acquisition is contained in Note 3 of the 2001 SBC Annual Report to Shareowners and is incorporated herein by reference pursuant to General Instruction G(2).

*Yahoo! Agreement*

In November 2001, we announced an agreement with Yahoo! to provide broadband access to customers in our 13-state area and co-branded dial-up service nationwide. This agreement will help our customers access our internet services virtually nationwide. We expect to begin offering the co-branded service with Yahoo! during the second half of 2002.

**Wireless**

Our wireless segment provides domestic wireless telecommunications services, including local, long distance and roaming services. Wireless services and products offered also include certain enhanced services, paging services and wireless equipment. Due to the contribution of substantially all of our domestic wireless operations to Cingular (discussed below), reported wireless results do not include revenues or expenses from the wireless joint venture; instead we reflect our 60 percent share of its net income as equity in net income of affiliates. However, for evaluating the results of Cingular internally, we use proportional consolidation. On that normalized basis, the wireless segment provided approximately 16 percent of our 2001 operating revenues; on an actual reported basis, less than one percent of our operating revenues came from our Wireless segment.

*Cingular Wireless Joint Venture*

In April 2000, we formed a joint venture with BellSouth to provide domestic wireless services nationally. In October 2000, most of our and BellSouth's wireless operations were contributed to Cingular, which then began operations. At December 31, 2001, Cingular served approximately 21.6 million customers, making it the second largest wireless operator in the United States. Economic ownership in Cingular is held 60 percent by us and 40 percent by BellSouth, with control shared equally. We are accounting for our interest under the equity method of accounting.

Additional information on Cingular is contained in Note 7 of the 2001 SBC Annual Report to Shareowners and is incorporated herein by reference pursuant to General Instruction G(2).

*SpectraSite Agreement*

In November 2001, we amended our August 2000 agreement with SpectraSite Communications, Inc. (SpectraSite) in which we granted SpectraSite the exclusive right to lease 3,900 communication towers for prepaid rents of $983 million in cash and SpectraSite common stock valued at $325 million, or $22.659 per share, at the August 2000 closing. We have agreed to reduce the maximum number of communication towers to be leased to SpectraSite to 3,600, and to extend the schedule for closing on towers until the first quarter of 2004. As consideration for those modifications, we received $35 million.

*Wireless Auction*

Cingular invested in a participant in a December 2000/January 2001 FCC auction of wireless spectrum licenses held by NextWave. A number of legal issues have emerged in connection with this auction and it remains subject to legal, legislative and regulatory proceedings.

Additional information on this auction is contained in the 2001 SBC Annual Report to Shareowners under the heading "Wireless" on page 20 which is incorporated herein by reference pursuant to General Instruction G(2).

**Directory**

Our directory segment includes advertising, Yellow and White Pages directories and electronic publishing. The directory operating segment provided approximately 8 percent of our normalized operating revenues in 2001.

Our directory subsidiaries operate primarily in our 13-state region.

**International**

Our international segment includes all of our investments with primarily international operations. We have direct or indirect interests in businesses located in more than 25 countries and as of December 31, 2001, have international investments with a carrying value of approximately $8.2 billion. Our international investments include local and long distance telephone services, wireless communications, voice messaging, data services, video services, Internet access, telecommunications equipment, and directory publishing.

*Europe*

We hold a 41.6 percent stake in TDC A/S (TDC) (formerly known as Tele Danmark A/S), Denmark's primary full-service communications operator. TDC has a 16.5 percent investment in Belgacom S.A. (Belgacom) as well as investments in wireless services in Poland, the Ukraine, Lithuania, Austria, the Netherlands and Germany. It has investments in competitive communications providers in Sweden, Germany, Switzerland and the Czech Republic. TDC also has investments in local telephone operations in Hungary and an international digital transmission link through Russia, Korea and Japan. SBC currently is able to elect six of twelve members of the TDC Board of Directors, including the Chairman, who would cast any tie-breaking vote.

In January 2001, TDC acquired a majority interest in diAx A.G (diAx), a wireless and long distance provider in Switzerland owned by SBC International and diAx Holdings.

In Belgium, we hold a 17.5 percent stake in Belgacom, the country's primary full-service telecommunications operator, and effectively own 24.4 percent of Belgacom when combined with our stake in TDC. With approximately 4.9 million access lines and more than 4.0 million cellular customers, Belgacom provides local, long distance, cellular and other communications services and offers directories and security services. Belgacom also has telecommunications investments in France and the Netherlands.

Belgacom has entered into an agreement with an unaffiliated special purpose entity (SPE) that allows Belgacom, at its discretion, the option to sell portions of its Netherlands wireless operations to the SPE in unspecified amounts until the end of 2002. In the fourth quarter of 2001, Belgacom sold a portion of its investment to the SPE, lowering its ownership percentage from 35 percent to 27 percent. As part of the transaction, Belgacom guaranteed the approximately $237 million in debt incurred by the SPE in the purchase. All holders of stock in the wireless company, including the SPE and TDC, which owns approximately 15 percent, have the right to put the stock to a subsidiary of Deutsche Telecom A.G. beginning January 2003. The SPE can put the shares at a price that is greater than the amount guaranteed by Belgacom.

We hold a 15 percent equity interest in Cegetel S.A. (Cegetel), a holding company, through a joint venture with France's Vivendi, a French diversified public company. Cegetel owns 80 percent of Societe Francaise du Radiotelephone, a wireless carrier in France with over 11.6 million customers. Cegetel offers both mobile and fixed line services.

*Asia*

In July 2001, we sold our interest in TransAsia Telecommunications Inc., a regional wireless telecommunications provider in southern Taiwan.

*North America*

We have a 20 percent stake in Bell Canada, Canada's premier telecommunications provider. Bell Canada offers services to more than 11.4 million residential and business customers, including local, long distance and wireless communications, Internet access, high-speed data services and directories.

From July 1, 2002 through December 31, 2002, we have the option to sell all of our Bell Canada shares to BCE Inc. (BCE) for an unspecified combination of cash and debt at fair market value plus 25 percent. Similarly, BCE has the right to purchase our Bell Canada shares during the same time frame at either the fair market value plus 25 percent or at our original investment amount compounded at an annual rate of 15 percent, whichever is greater. BCE is a publicly traded company with more than 23 million customer connections through its wireline, wireless, data and Internet, and satellite services. It is Canada's largest communications company and owns approximately 80 percent of Bell Canada. We currently do not know

# 5

Merger of

SBC Communications Inc.

and

AT&T Corp.

***Description of the Transaction, Public Interest Showing, and Related Demonstrations***

Filed with the Federal Communications Commission
February 21, 2005

## TABLE OF CONTENTS

**Attachments**:

- Description of Applicants
- Description of Competitors
- Declaration of James S. Kahan
- Declaration of Christopher Rice
- Declaration of Thomas Horton
- Declaration of John Polumbo
- Declaration of Hossein Eslambolchi
- Declaration of Dennis W. Carlton and Hal S. Sider
- Declaration of Marius Schwartz

parties and further decreasing the likelihood of collusion.[321] Large business contracts often generate enormous revenues, which give suppliers substantial incentive to win each contract, and create enormous lost opportunity costs when contracts are lost. Where "large buyers engage in long term contracting, so that the sales covered by such contracts can be large relative to the total output of a firm in the market, firms may have the incentive to deviate," especially where "the duration, volume and profitability of the business covered by such contracts are sufficiently large as to make deviation more profitable in the long term than honoring the terms of coordination, and buyers likely would switch suppliers."[322] Thus, for those businesses with needs beyond commodity voice, data, and converged services, marketplace conditions insure that the benefits of competition still flow to the customer.

C. AT&T and SBC Focus on Different Customer and Service Segments.

Although their businesses overlap in the provision of services to some business customers, SBC's and AT&T's strengths are far more complementary than competitive. Whereas AT&T's focus is increasingly on the largest enterprise customers with the most complex needs, SBC does not serve the needs of truly nationwide and international customers and instead focuses on customers with a predominance of locations within the

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Footnote continued from previous page
[320] Carlton & Sider Decl. ¶ 95.

[321] *See, e.g., Triennial Review Order*, 18 FCC Rcd. at 17063 ¶¶ 128-29 (Enterprise customers "are willing to sign term contracts" for their large packages of services.).

[322] Merger Guidelines, Section 2.12; *see also* Areeda & Hovenkamp, ANTITRUST LAW ¶ 404c4 (2d ed. 2002) (stating that where "sales opportunities are rare, . . . each [participant] has a powerful incentive to prevail at each opportunity").

SBC 13-state region plus the 30 out-of-region markets and who generally require less complex voice and data solutions.[323]

SBC's and AT&T's internal categorizations of business opportunities demonstrate their fundamentally different roles in the business marketplace. For SBC, any company with more than *$48,000* per year in business is considered an "Enterprise" customer.[324] For AT&T, the "Enterprise" label applies to customers expected to spend *$1 million* per year or more. Moreover, whereas AT&T separately categorizes companies expected to spend tens of millions of dollars or more annually as "Signature" customers, SBC has no such high-end segmentation.[325] As is suggested by this categorization, AT&T is focused on customers with the most geographically dispersed, complicated needs, whereas SBC is focused on (1) customers with more basic telecommunications requirements, and (2) customers with locations predominantly in its region and a limited number of out-of-region MSAs. The distance between the areas of competitive focus for the two companies would be unlikely to narrow in the foreseeable future even if the companies did not merge.[326]

AT&T has historically been a leading provider of a broad range of "primary" services and solutions for the largest (Fortune 1000) businesses. In particular, AT&T possesses two important assets that SBC could not economically create on a national or international basis in the near term: reputation and experience as a leading provider of complex voice and data services to the world's largest businesses, and an advanced

[323] Kahan Decl. ¶¶ 20, 24; *see* Carlton & Sider ¶¶ 6, 31.

[324] Kahan Decl. ¶ 22.

[325] *See* Carlton & Sider Decl. ¶ 105.

[326] Kahan Decl. ¶¶ 17-19.

network with both national and international scope. As Forrester Research recently summarized:

> AT&T's great strength lies in assets that SBC lacks; its enterprise business customer base and the national and global network that supports their requirements. To retain its status as enterprises' primary voice and data provider, AT&T offers multiple VPN and VoIP services and has modernized its network infrastructure and network management systems to state-of the-art status.[327]

As described above, given competitive market conditions, AT&T has recently undertaken to make best use of its resources by focusing on the most complex needs of the largest enterprise customers, with a concomitant shift of focus away from attracting customers in the mass market and smallest business segments.[328]

AT&T's focus on larger businesses and managed services forms a natural complement to SBC. SBC does not have a nationwide or global network or a track record of providing, or the expertise necessary to provide, the complex managed networks and services demanded by many customers, who already enjoy an intensely competitive marketplace populated by many established domestic and international network owners and systems integrators. As a result, although it operates a business called "Global and Enterprise Markets," SBC in fact focuses its competitive efforts on a limited subset of businesses centered in SBC's region.[329]

Most enterprise customers have needs outside of SBC's region and outside of SBC's 30 targeted MSAs, and these customers are particularly demanding of the most feature-rich, cost-effective, flexible, reliable and secure communications services

[327] Forrester Research, "SBC-AT&T Merger Makes Sense: Complementary Assets And Customer Bases Make A Logical Combination," at 2 (Feb. 4, 2005).

[328] Polumbo Decl. ¶¶ 2, 9; Horton Decl. ¶¶ 2,7.

available.[330] As indicated in connection with the 1999 SBC/Ameritech merger, SBC had aspired to become a more robust national player for the complex needs of these customers. Because SBC does not own its own dense national long-haul network, SBC attempted to serve those needs through an arrangement with WilTel, using WilTel's network. SBC found, however, that its particular arrangement with WilTel did not give it enough end-to-end network management control and flexibility to meet these customers demanding requirements for system integration and accountability, performance and provisioning and trouble-shooting speed and flexibility.[331] The capability seamlessly to integrate highly competitive international services and network capabilities has also become increasingly important, and SBC's arrangements with Infonet and other global providers likewise provided insufficient integration and network management control.[332]

Moreover, just as SBC was completing the Ameritech transaction and implementing its national/local strategy, the telecom sector suffered a major slowdown, retarding customer expenditures and heightening competition among the many established national and global suppliers that have spent years and decades cultivating reputations in this space, significantly limiting opportunities for growth. And SBC's initial investments in voice-centric out-of-region capabilities have been made less useful by the emerging emphasis on unified data networks.

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Footnote continued from previous page
[329] Kahan Decl. ¶ 22.

[330] *Id.* ¶¶ 24, 26.

[331] *Id.* ¶ 25.

[332] *Id.* ¶ 26.

At the same time, AT&T and the many other national network providers and system integrators have continued to enhance and improve their abilities to provide the differentiating managed and system integration capabilities and sophisticated network applications, such as call routing and service management tools that SBC has no track record in providing.[333] Although SBC has made substantial efforts to close the gap, those efforts have not created an effective competitor for large business customers with out-of-region national or international needs.[334] As one new AT&T customer has explained:

> "Many of our offices have different providers of telecommunications," said John Kozero, a Fireman's Fund spokesman. "There's no coherent connections. I can't send a voice mail to any other office on my own." Not only that, he said, but "if there's a problem, we have to run down a couple of dozen service providers" to find out who needs to fix what. "With a single provider, you have one throat to choke," he said. With AT&T's network, Kozero said, about 4,400 employees and 3,600 independent agents will be connected with fiber optics that will boost quality and speed of voice and information transmission. "We traded a couple of dozen vendors for one coherent provider that maintained the whole network," he said of AT&T. "That's their business."[335]

For all of these reasons, SBC focuses on customers with a predominant in-region presence. SBC's "Global and Enterprise Markets" sales, while marginally growing, remain predominantly focused on local services and equipment sales, and are a small

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[333] *Id.* ¶ 26; Almar Latour, *For SBC, Fading AT&T Offers A Rich Prize: Business Customers*, WALL ST. J., Jan. 28, 2005 at A1 ("But AT&T would fill a big gap in SBC's portfolio, SBC has trouble being taken seriously by the phone industry's most lucrative customers: big corporations who spend millions of dollars on phone and data services.").

[334] Kahan Decl. ¶ 27.

[335] Bobby White and Jim Fuquay, *SBC Bid for AT&T Could Mark End of Era*, FORT WORTH STAR-TELEGRAM, Jan. 28, 2005, *available at* http://www.rednova.com/news/display/?id=122886.

fraction of AT&T's and other significant national competitors' sales. As AT&T's CEO has noted:

> [T]he RBOCs are going to be most competitive in their regional footprint for companies that fit nicely in that. It's not to say they don't compete out of region, but the more they get away from their in region footprint, obviously, their cost structures change and they also have a deficit not only in facilities but actual service and support. And that's where, from both national and global type enterprises, we remain with a pretty clear differentiation.[336]

Whatever ability SBC might have in the future to compete for national customers, it plainly would have no unique advantages in that regard.[337] SBC has no greater ability to construct a national network, or provide national services over the facilities of other carriers, than many other providers seeking to become significant national and global players.[338] Accordingly, the proposed transaction should not raise concerns about a loss of potential SBC competition in the national and international enterprise marketplace. Indeed, as discussed above, the complementarity of SBC's and AT&T's strengths will uniquely offer business customers of all sizes numerous benefits that neither company is likely to achieve on its own.[339]

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336 AT&T Corp., Q4 Earnings Call (Jan. 20, 2005).

337 *Accord*, *MCI/WorldCom,* 13 FCC Rcd. at 18098-99 ¶¶ 128-29 (Where one of the merging parties is "not a significant competitor" in the market or do "not possess any special retail assets or capabilities that would make it more likely than other carriers to become a major participant in the mass market," the merger "is not likely to affect adversely competition.").

338 *See* Kahan Decl. ¶¶ 23-24.

339 *See* Carlton & Sider Decl. ¶¶ 35-37.

# DECLARATION OF JAMES S. KAHAN

**Senior Executive Vice President for Corporate Development**
**SBC Communications Inc.**

**In connection with the proposed transaction, SBC intends to file a registration statement, including a proxy statement of AT&T Corp., and other materials with the Securities and Exchange Commission (the "SEC"). Investors are urged to read the registration statement and other materials when they are available because they contain important information.** Investors will be able to obtain free copies of the registration statement and proxy statement, when they become available, as well as other filings containing information about SBC and AT&T Corp., without charge, at the SEC's Internet site (www.sec.gov). These documents may also be obtained for free from SBC's Investor Relations web site (www.sbc.com/investor_relations) or by directing a request to SBC Communications Inc., Stockholder Services, 175 E. Houston, San Antonio, Texas 78258. Free copies of AT&T Corp.'s filings may be accessed and downloaded for free at the AT&T Relations Web Site (www.att.com/ir/sec) or by directing a request to AT&T Corp., Investor Relations, One AT&T Way, Bedminster, New Jersey 07921.

SBC, AT&T Corp. and their respective directors and executive officers and other members of management and employees may be deemed to be participants in the solicitation of proxies from AT&T shareholders in respect of the proposed transaction. Information regarding SBC's directors and executive officers is available in SBC's proxy statement for its 2004 annual meeting of stockholders, dated March 11, 2004, and information regarding AT&T Corp.'s directors and executive officers is available in AT&T Corp.'s proxy statement for its 2004 annual meeting of shareholders, dated March 25, 2004. Additional information regarding the interests of such potential participants will be included in the registration and proxy statement and the other relevant documents filed with the SEC when they become available.

Certain matters discussed in this statement, including the appendices attached, are forward-looking statements that involve risks and uncertainties. Forward-looking statements include, without limitation, the information concerning possible or assumed future revenues and results of operations of SBC and AT&T, projected benefits of the proposed SBC/AT&T merger and possible or assumed developments in the telecommunications industry. Readers are cautioned that the following important factors, in addition to those discussed in this statement and elsewhere in the proxy statement/prospectus to be filed by SBC with the Securities and Exchange Commission, and in the documents incorporated by reference in such proxy statement/prospectus, could affect the future results of SBC and AT&T or the prospects for the merger: (1) the ability to obtain governmental approvals of the merger on the proposed terms and schedule; (2) the failure of AT&T shareholders to approve the merger; (3) the risks that the businesses of SBC and AT&T will not be integrated successfully; (4) the risks that the cost savings and any other synergies from the merger may not be fully realized or may take longer to realize than expected; (5) disruption from the merger making it more difficult to maintain relationships with customers, employees or suppliers; (6) competition and its effect on pricing, costs, spending, third-party relationships and revenues; (7) the risk that Cingular Wireless LLC could fail to achieve, in the amount and within the timeframe expected, the synergies and other benefits expected from its acquisition of AT&T Wireless; (8) final outcomes of various state and federal regulatory proceedings and changes in existing state, federal or foreign laws and regulations and/or enactment of additional regulatory laws and regulations; (9) risks inherent in international operations, including exposure to fluctuations in foreign currency exchange rates and political risk; (10) the impact of new technologies; (11) changes in general economic and market conditions; and (12) changes in the regulatory environment in which SBC and AT&T operate.

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# DECLARATION OF JAMES S. KAHAN
**Senior Executive Vice President for Corporate Development**
**SBC Communications Inc.**

I, James S. Kahan, hereby declare the following:

**Position and Qualifications**

1. My name is James S. Kahan. I am the Senior Executive Vice President for Corporate Development of SBC Communications Inc. ("SBC"). I received a Bachelor's degree in Electrical Engineering from Purdue University and a Master's degree in Business Administration from the University of North Carolina. I began my professional career as an engineer with Western Electric in 1967. Prior to joining Southwestern Bell Telephone ("SWBT") in 1983 I was transferred from Western Electric to Bell Laboratories, South Central Bell and AT&T. In 1984, I moved to SBC's Corporate Development Organization where I worked on the acquisition of Metromedia's cellular and paging systems and various other acquisitions. In 1988 I became Managing Director-Corporate Development and I was responsible for SBC's mergers and acquisitions activities and international business development. During this time I was involved in negotiating SBC's participation in a consortium which purchased an interest in Telefonos de Mexico ("Telmex"). I was appointed Senior Vice President for Corporate Development and became an Officer of SBC in 1992.

2. From 1993 through the present, I have been principally responsible for all of SBC's mergers and acquisitions activities and have participated in development of the company's long-term growth strategies. I have been actively involved in and responsible for the negotiation of SBC's acquisitions of Pacific Telesis Group, Southern New

England Telecommunications Corporation, Ameritech Corporation, and AT&T. I also was responsible for the negotiation of Cingular's acquisition of AT&T Wireless.

3. I have been directly involved in SBC's consideration of its strategic options to remain competitive in the rapidly transforming telecommunications industry. I am intimately familiar with the strategic imperatives that drove SBC to enter into the negotiations to acquire AT&T as well as with the analyses conducted in connection with our decision to undertake the merger.

**Purpose of Declaration**

4. In this Declaration I will:

- Discuss the rapid transformation that the telecommunications industry has experienced;
- Describe the effects of that transformation on legacy providers such as SBC and AT&T;
- Explain why the combination of SBC and AT&T will create a stronger competitor with the resources necessary to respond to the forces that are reshaping the telecommunications industry; and
- Describe the benefits of the acquisition for all consumers.

**The Technological Transformation of the Telecommunications Industry**

5. In the eight years since enactment of the Telecommunications Act of 1996 the telecommunications industry has been radically transformed. The Act created the conditions that stimulated unprecedented new competitive entrants and nurtured the development and enhancement of new technologies that have advanced at a breakneck pace to compete with and displace traditional telecommunications services. At the local level, a host of new providers have entered the market, using a variety of technologies to provide competition for traditional providers of local voice and data services.

AT&T has been a leader in the development of innovative products through its AT&T Labs.

20. As described in the Declarations of Thomas Horton and John Polumbo, in 2004 AT&T refocused its business strategy away from trying to provide all communications services to all customers, and determined instead to concentrate on providing complex communications solutions to large enterprise customers. As Mr. Polumbo details, AT&T made an irreversible decision to cease actively competing for mass market customers and to scale back its operations to retain only the infrastructure necessary to continue serving its rapidly declining base of mass market customers.

21. The combined SBC and AT&T will be a stronger and more enduring U.S.-based global competitor than either company could be alone, capable of delivering the advanced network technologies necessary to offer integrated, innovative high quality and competitively priced telecommunications services to meet the national and global needs of all classes of customers worldwide. The combined company will have the resources, expertise and incentive to adapt the sophisticated products that AT&T has developed for its enterprise customers to the needs of small and medium businesses and consumers, and the marketing expertise and infrastructure to reach those customers.

**The Merged Firm Will Be A Stronger Competitor.**

22. SBC's experience is that larger business customers demand unique and more customized telecommunications systems. These customers have more knowledgeable staff (and many use consultants) to prepare rigorous bid requirements, analyze proposals, use advanced bid procedures (including online or electronic bidding designed to encourage competitors both to undercut each other's prices and to out-deal

each other by offering more advanced bid responses), and negotiate terms. Among larger customers, these bids tend to be extensively tailored to the specific requirements of the business. These customers are often willing to combine or separate components of their systems and award them to different suppliers in order to tailor the most cost and performance effective solutions. Indeed, SBC processed about 30,000 custom pricing quotations for business customers during 2004, including custom bids for large enterprise customers. SBC's definition of an "Enterprise" customer is a business that generally purchases more than $48,000 in telecommunications services annually from SBC. Many of these customers require complex telecommunications products and services.

23. SBC has sought since the late 1990s to become a significant provider to enterprise customers at the national level. In support of that objective, SBC began in 1999 to make substantial investments to expand its geographic reach and the scope of its products and services to appeal to large national enterprise customers. Despite the commitment of significant resources and investment to execute the "National-Local" strategy we envisioned at the time of the Ameritech acquisition, the results so far have fallen short of our expectations. We have come to realize that acquisition of a firm that has the strengths and resources we lack is far more prudent than incurring the massive investment and time that, without a substantial likelihood of return in a reasonable period of time, would be required to develop them independently.

24. The "National-Local" strategy was our organic attempt to achieve in a reasonable time frame the critical mass of customers needed to achieve the scale and scope economies required to compete successfully in the large business segment. It involved the initial expansion to 30 out-of-region cities with an interconnecting backbone

network. We have so far spent in excess of $1 billion over five years comprising facilities, start-up sales and marketing costs, and introduction of SBC's products. Still, we find it very difficult to win a prime supplier role for large enterprise customers for reasons explained below.

25. To attempt to address its limited geographic presence out of region, SBC has formed strategic and commercial relationships to use third party networks for transport and local access in areas where we lacked our own network facilities. The most significant of these has been with Wiltel. Large business customers are, however, often hesitant to award SBC major contracts because it cannot guarantee its ability to manage and control the networks over which the service is provided. The reason for this reluctance is that on-net traffic is better controlled by the primary network provider; there is less opportunity for delays or trouble at network-to-network interconnect points, less risk of missed orders or provisioning delays between networks, and on-net providers can control all of the network elements and give the highest degree of accountability and performance, among other reasons.[11]

26. SBC's efforts to expand out-of-region also included working to expand our product portfolio, especially for data and converged voice-data services. SBC's historic strength has been in the consumer and small-to-medium business segments of the marketplace. These consumer and smaller business customers, in addition to being more local or regional, have to-date required less sophisticated products and service, both for voice and data communications. Large enterprises, on the other hand, are extremely demanding of the most feature-rich, cost-effective, flexible, reliable, and secure

[11] *See* Declaration of Christopher Rice, ¶¶6-18.

communications services available. It is common for large enterprises to impose very high service level requirements on their network provider. These commitments, known as Service Level Agreements (or SLAs), can apply to a broad range of things, including minimum provisioning intervals, minimum up-times and availability, maximum tolerances for throughput delays or errors, etc., and often impose financial penalties for failure to perform to the specified SLAs. Like the task of creating a national and international network for purposes of geographic expansion, this product development effort to meet the needs of large enterprise customers is extremely costly and time consuming, and SBC continues to lag significantly behind companies like AT&T, MCI, and system integrators, which have continued to enhance and improve their abilities to provide the differentiating managed and system integration capabilities and sophisticated network applications, such as call routing and service management tools, that SBC has no track record in providing.

27. For the reasons described above, our competitive success is greatest among consumer and smaller business customers. As we have begun to compete for larger business customers, our success rate likewise has been greatest with customers that are predominantly within our region and those with fewer locations. By contrast, our success is much more limited with larger enterprises, particularly with those business customers with a large portion of their locations outside of our region. In fact, recognizing our competitive disadvantage with larger business customers that have a significant portion of their locations outside our region, our sales strategies identify and pursue only those accounts that we are best suited to serve, namely those that closely fit the description of our past successes. SBC focuses its attention on competing to provide

services to business customers in its "sweet spot," which refers to businesses with locations predominantly located within SBC's footprint. That is, SBC typically does not even try to compete for business where more than half of the customer's locations are out of its footprint or where more than 20% of the traffic is international. This eliminates a large portion of potential enterprise customers. Given our relative lack of geographic scope, product portfolio and established reputation among this segment of the market, we do not believe that we will be able to compete effectively for a prime supplier role for the majority of the largest enterprise customers in the foreseeable future.

28. The combination of the complementary strengths of SBC and AT&T will result in a more effective competitor in all customer segments. The merged firm will be a financially stronger competitor, able to deliver the advanced network technologies necessary to offer integrated, innovative, high quality and competitively priced telecommunications services to all customers.

29. The combined company will have the financial ability to continue cutting edge research and product development. Because of its broader and more diverse customer base, the combined company will have a greater incentive to invest in R&D and capital improvements. SBC expects higher capital spending (totaling approximately $2 billion before synergies over the first few years after closing) than would likely have been incurred by the two companies absent the merger.

30. The combined company will have enormous incentive to innovate, raise productivity, and improve the price/performance of its products as it meets the continuing competitive threat of both traditional competitors, customer-premise equipment

**DECLARATION OF**

**DENNIS W. CARLTON**

**and**

**HAL S. SIDER**

future revenues and results of operations of SBC and AT&T, projected benefits of the proposed SBC/AT&T merger and possible or assumed developments in the telecommunications industry. Readers are cautioned that the following important factors, in addition to those discussed in this statement and elsewhere in the proxy statement/prospectus to be filed by SBC with the Securities and Exchange Commission, and in the documents incorporated by reference in such proxy statement/prospectus, could affect the future results of SBC and AT&T or the prospects for the merger: (1) the ability to obtain governmental approvals of the merger on the proposed terms and schedule; (2) the failure of AT&T shareholders to approve the merger; (3) the risks that the businesses of SBC and AT&T will not be integrated successfully; (4) the risks that the cost savings and any other synergies from the merger may not be fully realized or may take longer to realize than expected; (5) disruption from the merger making it more difficult to maintain relationships with customers, employees or suppliers; (6) competition and its effect on pricing, costs, spending, third-party relationships and revenues; (7) the risk that Cingular Wireless LLC could fail to achieve, in the amount and within the timeframe expected, the synergies and other benefits expected from its acquisition of AT&T Wireless; (8) final outcomes of various state and federal regulatory proceedings and changes in existing state, federal or foreign laws and regulations and/or enactment of additional regulatory laws and regulations; (9) risks inherent in international operations, including exposure to fluctuations in foreign currency exchange rates and political risk; (10) the impact of new technologies; (11) changes in general economic and market conditions; and (12) changes in the regulatory environment in which SBC and AT&T operate.

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I, Dennis W. Carlton, hereby declare the following:

I, Hal S. Sider, hereby declare the following:

## I. QUALIFICATIONS

1. I, Dennis W. Carlton, am Professor of Economics at the Graduate School of Business of The University of Chicago. I have served on the faculties of the Law School and the Department of Economics at The University of Chicago and the Department of Economics at the Massachusetts Institute of Technology. I specialize in the economics of industrial organization, which is the study of individual markets and includes the study of antitrust and regulatory issues. I am co-author of Modern Industrial Organization, a leading textbook in the field of industrial organization, and I also have published numerous articles in academic journals and books. In addition, I am Co-Editor of the Journal of Law and Economics, a leading journal that publishes research applying economic analysis to industrial organization and legal matters.

2. In addition to my academic experience, I am a Senior Managing Director of Lexecon, an economics consulting firm that specializes in the application of economic analysis to legal and regulatory issues. I have served as an expert witness before various state and federal courts and foreign tribunals and I have provided expert witness testimony before the U. S. Congress. I have submitted testimony before the Federal Communications Commission in a number of matters. In 2004, I was appointed to the Antitrust Modernization Commission, a 12-member commission created by Congress to review U.S. antitrust laws. I have previously served as a consultant to the Department of Justice regarding the Merger Guidelines of the Department of Justice and Federal Trade Commission, as a general consultant to the Department of Justice and Federal Trade Commission on antitrust matters, and as an advisor to the Bureau of the

Census on the collection and interpretation of economic data. A copy of my curriculum vita is attached in Appendix 1 to this affidavit.

3. I, Hal S. Sider, am a Senior Vice-President of Lexecon. I received a B.A. in Economics from the University of Illinois in 1976 and a Ph.D. in Economics from the University of Wisconsin (Madison) in 1980. I have been with Lexecon since 1985, having previously worked in several government positions. I specialize in applied microeconomic analysis and have performed a wide variety of economic and econometric studies relating to industrial organization, antitrust and merger analysis. I have published a number of articles in professional economics journals on a variety of economic topics and have testified as an economic expert on matters relating to industrial organization, antitrust, labor economics and damages. In addition, I have provided economic testimony on telecommunications issues on a variety of matters before the FCC and state public utility commissions. A copy of my curriculum vita is attached in Appendix 1 to this affidavit.

## II. INTRODUCTION AND OVERVIEW

4. We have been asked by counsel for SBC Communications Inc. (SBC) and AT&T Corp. (AT&T) to present our assessment of competitive issues raised by the proposed merger of these firms. This initial assessment is based on our general familiarity with developments in the telecommunications industry, our extensive review of public source data and information provided by the companies to date.[1] We will continue to review and analyze additional data and documents during the course of this proceeding and use that information to respond to any issues raised by the Parties' Application or otherwise supplement our analysis as appropriate.

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1. We understand that the Parties will be submitting to the Commission additional non-public information when a protective order is in place. This information, when it is available to be reported, will enable us to make more precise several of the statements in this filing.

5. The proposed transaction will promote competition by creating a more efficient firm which will achieve significant cost savings and will be better positioned to develop and deploy new products and services for business and residential customers. In addition, our analysis to date indicates that the transaction is unlikely to create significant competitive problems due to a variety of characteristics of the industry and Parties, including: (i) the largely complementary nature of AT&T's and SBC's networks, services and target customers; (ii) the rapid on-going pace of developments in telecommunications technology; (iii) AT&T's prior decision to cease marketing its services to residential and small business customers; (iv) the growth of facilities-based competition for both businesses and residential consumers; and (v) the sophistication and purchasing practices of business customers as well as the importance of non-price dimensions of telecommunications services.

6. The major conclusions explained in this Declaration are as follows:

- SBC's and AT&T's businesses are largely complementary, with SBC operating a dense local network in its region and AT&T operating an extensive national and global network. Similarly, SBC is majority owner of a leading facilities-based wireless carrier while AT&T does not own wireless facilities and does not at present market wireless services. The firms also focus on serving different sets of customers, with AT&T increasingly focusing its efforts on serving large business customers with national or global needs while SBC maintains a predominantly regional focus.
- Rapid technological changes are expanding the competitive alternatives available to all consumers – including residential, small business and large business subscribers. For example, the rapid growth of Internet Protocol (IP) technology is blurring the distinction between voice and data services, and

increasing the number of firms competing with legacy carriers to provide service to all categories of customers.

- Changes in technology, regulation and business strategy mean that historical and current measures of the extent of competition between the firms overstate any potential reduction in competition resulting from the proposed transaction.
    - AT&T's decision to cease marketing traditional services to residential consumers and small businesses means that it will rapidly cease to be a significant competitive factor in serving these customers in the absence of the transaction.
    - Moreover, residential customers that would have remained with AT&T in the absence of the transaction are likely to benefit from the merger because SBC, which has no plans to exit, does not face the same incentives as AT&T to raise prices to this group.
- Where SBC and AT&T both compete to provide a variety of data and voice services to certain business customers, they face a wide variety of competitors and conditions that make it unlikely that the transaction will harm competition either through coordinated or unilateral actions.
    - In providing service to certain business customers, SBC and AT&T face competition from interexchange carriers (IXCs), new network providers, competitive local exchange carriers (CLECs), systems integrators, equipment providers, value-added resellers and cable providers.
    - The sophistication of business consumers, the importance of non-price dimensions of service and the large and infrequent nature of the

"bidding" contracts at issue reduce the potential for the transaction to adversely affect competition.

- The transaction is unlikely to adversely affect competition for wireless services, where AT&T today has only limited plans to provide service as a reseller or mobile virtual network operators (MVNO). Similarly, the transaction is unlikely to adversely affect competition in the provision of Internet telephony, where AT&T is one of many new entrants and faces significant competition from cable companies and other providers.
- By combining firms with complementary networks and businesses, the transaction will benefit consumers by:
    - Enabling the merged firm to provide services now available to AT&T's large business customers to a wider range of business customers;
    - Increasing incentives to invest in new products and services by enabling innovations to be deployed to the combined firm's larger customer base.
    - Enabling the merged firm to provide "end-to-end" services to an increased number of multilocation business customers and thus to improve service reliability;
    - Enabling the merged firm to operate at substantially lower costs than those that AT&T and SBC would face separately, thus enabling it to compete more effectively against new firms deploying new, lower-cost technologies.

7. The remainder of this declaration provides the basis for these initial conclusions. Section III presents: (i) background information on SBC and AT&T; (ii) background regarding trends in the demand for wireline telecommunications services; and (iii) an overview of consumer benefits resulting from the transaction. Section IV addresses the competitive impact of the transaction on consumer services, including wireless services. Section V reviews factors that affect the impact of the transaction on services used by business customers.

## III. THE PROPOSED TRANSACTION IS LIKELY TO RESULT IN SIGNIFICANT BENEFITS TO CONSUMERS.

### A. BACKGROUND ON THE MERGING PARTIES

#### 1. AT&T

8. AT&T provides local and long distance voice services as well as an array of local and long distance data services. It serves business customers of all sizes -- from small firms to large multinational enterprises – as well as residential customers, although it is no longer marketing its traditional services to the latter group. In 2004:[2]

- Business services accounted for 74 percent of AT&T's revenue, with 26 percent from consumer services, although the share accounted for by consumers is declining rapidly.
- Long distance voice services accounted for 84 percent of AT&T's voice revenue, with 16 percent coming from local voice services.

2. AT&T Corp. Fourth-Quarter and Full-Year 2004 Financial Results, Historical Segment Data, January 20, 2005.

- AT&T undertook extensive headcount reductions in its Consumer unit in areas relating to marketing and customer care and plans further headcount reductions through 2005.[13]
- AT&T has also retired much of the infrastructure that it used to acquire and serve residential customers.[14]

**2. SBC**

14. SBC provides local and long distance voice as well as local and long distance data services, primarily in a 13-state region. SBC's mix of service revenue differs significantly from that provided by AT&T. In 2004, for example:

- Business services accounted for 48 percent of SBC's retail wireline revenue, with 52 percent derived from consumer services.[15]
- Long distance voice services accounted for 14 percent of SBC wireline voice revenue, with 86 percent coming from local voice services.[16]

15. SBC's revenue, unlike AT&T's, has grown in recent years. Since receiving authorization to provide long distance services in each state in which it operates between 2000 and 2003, SBC has rapidly expanded its provision of long distance services. It now provides long distance to 44 percent of its local service customers.[17] SBC's wireline revenues have also increased as a result of the sale of DSL services. SBC now has over 5 million DSL lines in

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13. See Declaration of John Polumbo.
14. See Declaration of John Polumbo.
15. Based on internal SBC documents.
16. SBC 4Q04 Earnings Information, http://www.sbc.com/Investor/Financial/Earning_info/docs/Segments_IB_4Q04.xls
17. UBS, Wireline Telecom Play Book, January 14, 2005, p.20.

service.[18] In addition, SBC owns a 60 percent economic interest in Cingular Wireless, one of the leading wireless service providers, which serves both businesses and consumers.

16. SBC's authorization to provide long distance services also enabled it to expand provision of voice and data services to multilocation business customers. SBC uses WilTel and others to transport its long distance traffic.[19] In 2003, SBC launched an initiative to expand SBC's provision of voice and data services to multilocation business customers. It deployed facilities on a limited basis in 30 metropolitan areas outside of its 13-state footprint. Based on its experience in the marketplace, SBC has decided to focus its attention on seeking to serve business customers with locations predominantly located within SBC's footprint.[20] SBC typically does not compete for business where more than half of the customer's locations are out of its footprint or where 20 percent or more of the traffic is international.[21]

## B. FACTORS AFFECTING THE DEMAND FOR TRADITIONAL WIRELINE SERVICES

### 1. General Trends

17. Dramatic changes in technology and regulation are resulting in fundamental changes in the competitive landscape for the provision of wireline services. These factors have placed increased competitive pressure on suppliers of wireline services for all types of consumers. These phenomena, and others, have reduced demand for traditional wireline services.

18. 4Q04 Investor Briefing, January 26, 2005.
19. See Declaration of James Kahan.
20. See Declaration of James Kahan.
21. See Declaration of James Kahan.

29. Analysts view the VoIP products being rolled out by cable operators as a direct competitive threat to the ILECs. Morgan Stanley concludes that "[t]he introduction of VoIP, especially by cable companies, represents the largest long-term competitive threat to the Bells, in our view."[38] Other analysts agree:

> During the end of 2004 cable companies made significant moves into the telecom space. It was reported that Time Warner ... expects to have 200K Digital Phone subscribers by 2004 end, and is currently adding 10K subscribers per week. CableVision ... passed the 250K telephony subscribers milestone and its Optimum Voice service has been adding 1,000 customers per day in the New York area. Comcast ... continued to discuss plans to offer phone service to 40M homes by the end of 2006.... Going forward, we see RBOC competitive pressures increasing as internet telephony services become more feature rich, cable services become more on-demand orientated, and consumers crave more integrated offerings.[39]

## C. THE MOTIVATION FOR THE PROPOSED TRANSACTION AND POTENTIAL CONSUMER BENEFITS

30. The proposed transaction reflects the companies' response to fundamental changes in the demand and supply of telecommunications services and is expected both to result in substantial cost savings and to bring substantial benefits to consumers. The cost savings and consumer benefits are described in greater detail in the accompanying declarations of SBC's James Kahan and Christopher Rice and AT&T's Hossein Eslambolchi.

### 1. The transaction combines firms with complementary networks and business focuses.

31. As discussed above, AT&T's and SBC's operations are highly complementary. For example, AT&T operates a dense national and international long distance network and has limited assets used to provide local services. SBC operates a dense local network in 13 states and has limited out-of-region and long distance assets. The combination of these networks

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38. Morgan Stanley, "3Q04 Trend Tracker: Let the Good Times Roll?" December 2004, p. 22.
39. Blaylock Partners, "Telecommunications: Wireline Services," January. 20, 2005, p. 2

management.[49] These headcount reductions result from the deployment by SBC of AT&T technology that enables customers to make orders and request repairs through computer-based systems. As noted above, AT&T has deployed systems that simplify the ordering, provision and repair processes for business customers.[50]

## IV. CONSUMER SERVICES

40. This section addresses issues relating to the competitive effect of the proposed transaction on services sold to consumers (including residential and very small business customers with under five lines). While AT&T has long been a major provider of long distance services to residential consumers and has provided local services on a resale basis in recent years, its declining sales as well as its recent decision to cease marketing traditional services to consumers means that current and historical information on AT&T's activities is not relevant for evaluating the impact of the proposed transaction on consumers. Additionally, the proposed transaction will have no significant competitive effect on the provision of wireless and VoIP services.

### A. CONSUMER SERVICES SOLD BY AT&T AND SBC

#### 1. AT&T

41. As noted above, consumer services account for roughly 25 percent of AT&T's 2004 revenue, although this figure is expected to decline rapidly due to AT&T decision to cease marketing consumer services.[51] Roughly 65 percent of AT&T's consumer services revenue is from "stand alone long distance" (i.e., consumers that do not obtain local service from AT&T)

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49. SBC, "SBC + AT&T A Premier Provider for a New Era of Communications," Special Analyst Meeting Notes, February 1, 2005, p. 34.
50. See Declarations of James Kahan and Hossein Eslambolchi.
51. AT&T Corp. Fourth-Quarter and Full-Year 2004 Financial Results, Historical Segment Data, January 20, 2005.

while 35 percent of consumer revenue is from subscribers that purchase a local/long distance bundle.[52] The local component of such bundles reflects resold ILEC services purchased at TELRIC-based rates for the unbundled network elements platform (UNE-P). As discussed earlier, AT&T no longer markets local/long-distance bundles or stand-alone long distance services, nor does it attempt to win back customers that it has lost. AT&T executives have characterized their current position as "harvesting" the business and as an "exit over time."[53]

42. AT&T has recently introduced AT&T CallVantage service, a voice-over-Internet-Protocol (VoIP) service in 100 MSAs. This service is provided using a broadband Internet connection, with calls transmitted through the public Internet for termination on the public switched network or with other VoIP subscribers. AT&T CallVantage service offers unlimited local and long distance calling for $30 a month, although customers must separately have a broadband Internet connection.[54] We understand that at the end of 2004, AT&T CallVantage had significantly fewer subscribers than other major providers of VoIP services.[55]

**2. SBC**

43. As discussed above, more than half of SBC's retail wireline revenue in 2004 reflected sales to residential consumers.[56] These revenues were distributed as follows: [57]

- Local voice services account for roughly 70 percent of SBC's 2004 consumer revenue. Local services for consumers remain subject to price regulation in each of the 13 states in which SBC operates.

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52. AT&T Corp. Fourth-Quarter and Full-Year 2004 Financial Results, Historical Segment Data, January 20, 2005.
53. AT&T 4Q04 Earnings Conference Call, January 20, 2005, p. 8.
54. http://www.usa.att.com/callvantage/plans/index.jsp
55. As noted above, we understand that the Parties will be submitting to the Commission more specific non-public information after a protective order is in place.
56. These calculations exclude revenue attributable to Cingular as well as SBC's resale of EchoStar's Dish Network satellite television services.
57. Based on internal SBC documents.

- Long distance services account for 16 percent of SBC's 2004 wireline consumer revenue. Other than SNET operations which it acquired, SBC entered into the provision of long distance service when it gained §271 approval for Texas in June 2000. By the end of 2003, SBC had been authorized to sell long distance in each of the 13 states in which it operates as an ILEC.[58]
- DSL accounts for about 10 percent of SBC's 2003 wireline consumer revenue.[59]

44. SBC offers each of these voice services on a stand alone basis or in various bundles, including "all-distance" voice bundles that include local and long distance services.

### B. AT&T'S HISTORICAL AND CURRENT ROLE IN THE PROVISION OF CONSUMER SERVICES IS NOT RELEVANT FOR EVALUATING THE COMPETITIVE IMPACT OF THE PROPOSED TRANSACTION

45. In recent years, AT&T, MCI and others offered local services by reselling ILECs' local service based on UNE-P at TELRIC-based rates. The final chapter in this long history is reflected in the FCC's recent rules that phase out by early 2006 ILECs' obligation to offer UNE-P service.[60] As described above, the FCC's decision to end ILECs' obligation to offer UNE-P at TELRIC-based rates contributed to AT&T's decision to stop marketing local and long distance services to consumers.[61]

46. AT&T's decision to cease marketing consumer services and to "harvest" its customer base means that, in the absence of the proposed transaction, AT&T's current and

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58. http://www.fcc.gov/Bureaus/Common_Carrier/in-region_applications/
59. Based on internal SBC documents.
60. FCC, Order on Remand, FCC 04-290, February 4, 2005, ¶199.
61. The Declaration of John Polumbo discusses in more detail how the change in the FCC's regulations affected AT&T's ability to compete for consumers. For the announcement see, http://www.att.com/news/2004/06/23-13121

added" resellers of other carriers' wireless services, such as Virgin and Qwest.[72] After deciding in 2004 to cease marketing to consumers, AT&T decided to scale back its efforts and seek to provide wireless services to large business customers only.[73]

57. The loss as the result of this transaction of a narrowly focused entrant reseller would not be expected to adversely affect competition. The wireless industry already has many competitors. There are several national facilities-based wireless carriers, as well as regional facilities-based carriers and other resellers.[74] The FCC recently examined these factors and concluded that "there is effective competition in the [wireless] marketplace."[75] In October 2004, the FCC approved (subject to minor conditions) the merger of two of six national facilities-based wireless carriers (AT&T Wireless and Cingular).[76] These factors, and the FCC's recent analyses, indicate the proposed transaction will not harm competition in the provision of wireless services.

## V. BUSINESS SERVICES

### A. DESCRIPTION OF SERVICES

58. Business voice and data services offered by SBC and AT&T are described in detail in the Application and related filings. This section provides a brief overview of the scope of competition in the provision of business services and assesses the potential impact of the transaction on competition for various business voice and data services.

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72. FCC, Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services, Ninth Report, WT Docket No. 04-111, September 9, 2004, at paras 39-40, and http://wirelessreview.com/ar/wireless_qwest_revisits_history/
73. See, for example, AT&T 4Q04 Earnings Conference Transcript, January 20, 2005, p. 2.
74. See, for example, FCC, Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services, Ninth Report, WT Docket No. 04-111, September 9, 2004, ¶36.
75. FCC, Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services, Ninth Report, WT Docket No. 04-111, September 9, 2004, ¶2.
76. FCC, Memorandum Opinion & Order, *In the matter of Applications of AT&T Wireless Services, Inc. and Cingular Wireless Corporation For Consent to Transfer Control of Licenses and Authorizations*, FCC 04-255, ("Cingular-AT&T Order") 10/26/04, ¶147.

59. As a general matter, business voice revenue fell three percent between 2003 and 2004 and is forecast to decline eight percent over the next two years. By contrast, business data traffic is expected to grow significantly, although business data revenues are expected to grow more slowly than traffic due to increased competition and productivity.[77]

60. While both SBC and AT&T today provide both local and long distance business services, including both voice and data services, there are substantial differences in the mix of services each provide and the customers that are the focus of each company's efforts.

**1. AT&T Business Services**

61. AT&T offers a variety of services to its business customers, including local voice service (provided through dedicated access and UNE-P to certain smaller business customers); long distance voice services, including domestic and international long distance; data services, including frame relay, ATM, IP VPN, and private lines; and managed services that include network design, maintenance, security, web hosting and desktop implementation.[78] AT&T's long distance voice revenues for business services account for 85 percent of its total business voice revenues.[79] The local/long distance mix of AT&T's data revenues is similar.

62. As discussed above, AT&T has stopped marketing to consumers (including businesses with less than five lines), is "becoming much more selective in [its] approach to the small business market ..." and is focusing on serving large business and government customers.[80] The same reasons that lead AT&T to stop marketing to consumers would likely cause it to reduce its efforts to serve smaller business customers as well.

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77. In-Stat, Wireline in Decline, December 2004, pp.18, 24.
78. See www.business.att.com
79. AT&T Corp. Fourth-Quarter and Full-Year 2004 Financial Results, Historical Segment Data, January 20, 2005.
80. AT&T Earnings Conference Call, January 20, 2005. (Reported by Thomson StreetEvents, pp. 3-4).

### 2. SBC Business Services

63. SBC also offers a variety of services to business customers, including local voice and data service and, since receiving regulatory approval in recent years, long distance voice and data services.[81] SBC's retail business voice revenues are 86 percent local and 14 percent long distance.[82]

64. In 2000 and 2001, SBC attempted to enter into the provision of enterprise services and deployed facilities in 30 out-of-region territories. These efforts, however, were largely unsuccessful.[83] As discussed above, SBC in 2003 began an initiative with the goal of providing enterprise services to multilocation customers, focusing on firms with locations inside of SBC's 13-state territory.

## B. ENTRY AND TECHNOLOGICAL CHANGES HAVE CREATED INCREASED COMPETITION IN THE PROVISION OF BUSINESS SERVICES

65. In recent years the widespread entry of new facilities-based telecommunications providers throughout the United States has created a variety of new competitors for both local and long distance data and voice services. Entry by service providers has been facilitated by large increases in fiber optic capacity deployed in long haul and local networks. Carriers including Qwest, Level 3, Global Crossing, Williams, Broadwing and others deployed extensive long distance fiber networks. At the same time, CLECs including AT&T (TCG), MCI (MFS, Brooks), Time Warner, Focal, as well as the new long distance providers deployed fiber networks within metropolitan areas, typically to serve central business districts.

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81. See Declaration of James Kahan.
82. Based on internal SBC documents.
83. See Declaration of James Kahan.

6

Analysis
Financial Post: Canada
**BCE, SBC alliance a partnership with no progress: What was supposed to be a deal to promote synergies has grown into one of diverging agendas**
Mark Evans
Financial Post
837 words
28 March 2002
National Post
FINP
National
FP7
English


When **BCE** Inc. sold 20% of Bell Canada to Ameritech Corp. in 1999, it was hailed as strategic coup that would give **BCE** access to technology, services and research, as well as footholds in the U.S. and European markets. And there was the $5.1-billion that **BCE** fetched from Ameritech.

Three years later, few of the benefits seem to have materialized. San Antonio, Tex.-based **SBC** Communications Inc., which acquired Ameritech, and **BCE** have pursued divergent strategic agendas. What appeared to be an important telecommunications **alliance** has become **a** passive investment for **SBC**, and **a** potential albatross for **BCE**.

"The original idea was this would lead to an **alliance** between the two companies," said John Grandy, an analyst **with** Yorkton Securities Inc. "They would work together on marketing, developing new products, and look at sharing costs. **BCE** was hopeful **SBC** would get involved in Teleglobe. Unfortunately, very little of that has actually happened."

The relationship took an interesting twist this week when it was reported **SBC** could exercise **a** put option between July and December that would require **BCE** to re-acquire the 20% stake in Bell Canada at fair market value, plus **a** 25% premium. Analysts estimate **BCE** would have to pay $7.2-billion to $7.5-billion.

While few analysts expect **SBC** to trigger the option this year, some people believe **SBC** will exercise the clause during **a** buyout window in 2004. Speculation about this possibility was heightened when an **SBC** spokesman said that while the Bell Canada investment was of "strategic importance", **SBC** had made **no** decision on whether or not it would exercise the option. In **a** market in which investors want transparency and clarity, it came across as **a** wishy-washy statement that left investors **with** more questions than answers.

Given the unclear situation, it is important to take **a** closer look at the **SBC-BCE** relationship -- or the lack thereof.

- In the long-haul carrier market, it was thought **SBC** would capitalize on **BCE**'s ownership of Teleglobe Inc. to handle its international traffic. That has not happened.

- In the fast-growing wireless market, it would make sense for **SBC** and **BCE** to pursue **a** strategy to provide benefits to both companies. Instead, **SBC** uses TDMA and GSM digital technology through its 60% stake in Cingular Wireless, while **BCE**'s Bell Mobility uses CDMA technology. CDMA is not compatible **with** TDMA or GSM.

- **SBC** and **BCE** have gone separate ways in the e-commerce business. In 2000, **SBC** acquired Sterling Commerce Inc. for US$3.9-billion. Sterling, which makes business-to-business software, competes against **BCE** Emergis Inc., 65% owned by **BCE**.

- **SBC** and **BCE** have different approaches to content and Web portals. Rather than have its own proprietary content and **a** Web portal, **SBC** struck an **alliance with** Yahoo! Inc. last November. The companies have teamed up to offer consumer co-branded high-speed and dial-up access services in **SBC**'s 13-state service region. Yahoo will also bundle some of its premium services, and the companies will promote the service through their own advertising campaigns. **BCE**, meanwhile, has an **alliance with** Lycos Inc., and acquired CTV Inc. and The Globe & Mail to provide content for its Sympatico.ca portal.

"In the obvious areas where they should co-operate, there hasn't been much co-operation," said Dvai Ghose, an analyst **with** CIBC World Markets, who believes the two companies have not done more together because **BCE** chief executive Jean Monty is unwilling to play second-fiddle to**SBC** and its CEO Edward Whitacre.

**SBC** has the luxury of time before it must make **a** decision about Bell Canada. It receives $200-million **a** year in dividends from an investment in **a** company that is enjoying solid growth and increasing value. As well, **SBC** does not need the cash because it is under-leveraged **with a** debt to EBITDA ratio of about 1:1.

If **SBC**, which has talked about having **a** North American strategy, waits until 2004, it will also providethe company **with** more time to consider its strategic options in Canada and the U.S. **SBC** is hoping Canada's foreign investment rules will be relaxed or removed -- paving the way for it to make **a** takeover bid for Bell Canada. There is also the possibility **SBC** will want to capitalize on consolidation **with** the U.S. telecom market, particularly the wireless industry. If **SBC** wants to make **a** move, it could raise cash by selling its stake in Bell Canada.

"The ball is clearly in **SBC**'s court," said Mr. Ghose. "**BCE** is passive and waiting for something to happen."

mevans@nationalpost.com

Black & White Photo: Jim Sulley, The Associated Press / **SBC**'S EDWARD WHITACRE JR.: Going head to head against **BCE**'s Jean Monty?

Document finp000020020328dy3s00052

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Ex 22

| Domestic corporations with operations solely in the U.S. | |
|---|---|
| **Ameritech Communications International, Inc.** | Provided long distance services between local calling areas in the states serviced by former Ameritech companies. |
| **Ameritech Global Gateway Services, Inc.** | Wholesale long distance services between local calling areas in the states serviced by former Ameritech companies were reported by this entity. It had no payroll. Company was inactive in 2002. |
| **SBC Global Services Inc.** | Sales and service of customer premises equipment within the U.S. |
| **Worldwide Directory Products Sales, Inc.** | Sales of excess inventory of Yellow/White Pages directories to buyers outside of the 13-state region were booked in this entity. It had no payroll. |

| Companies formed to hold or service nonbusiness foreign investments. Except as noted, most were either passive holding companies or inactive during these years. | |
|---|---|
| **SBC International** | Primary holding company that directly or indirectly held SBC's nonbusiness foreign investments, including investments in Telmex, Cegetel, diAx, and TransAsia. |
| **SBC International Development Corporation** | Formed to Investigate and develop International business opportunities. SBC International Development Corporation was formerly known as Southwestern Bell International Development Corporation. |
| **Ameritech International, Inc.** | Primary holding company for Ameritech's nonbusiness foreign investments. Held holding companies that owned investments in TeleDanmark, Belgacom, and Bell Canada. |
| **Ameritech Denmark, Inc.** | Set up to be the payroll company for the Legacy Ameritech expatriates assigned to foreign investments. |
| **SBC International Management Services, Inc.** | This company employed all of the Legacy SBC expatriates. |
| **SBC International Europe** | Set up to identify potential foreign investment opportunities. |
| **SBC International Realty Corporation** | Set up to own real estate (housing) for expatriates assigned to the nonbusiness investment in South Africa. |
| **Ameritech Canada, Inc.** | Trustee in a trust formed to hold the nonbusiness Bell Canada stock investment. No other operations. |
| **SBC International Global Holdings, Inc.** | Holding company formed to hold an interest in a Romanian investment. |
| **SBC World Holdings, Inc.** | Holding company for a 10% interest in a nonbusiness Israeli investment that was sold prior to 2001. It was dissolved on 8/23/01. |
| **Southwestern Bell International Holdings (UK-1) Corporation** | Formed to be a partner in SBC CableComms, a British Cable investment that was sold in the 1990s. No other activity, and it was dissolved on 8/23/01. |
| **French American Cellular Investment Corporation.** | A holding company for a minority interest in a wireless investment. SBC owned 22% of this company prior to May 2001. |
| **SBC Global Communications, Inc.** | A holding company for an interest in an undersea cable venture. This company was inactive in 2001 and dissolved on 8/23/01. |

| | |
|---|---|
| Ameritech Denmark Funding Corporation | Holding company for part of SBC's nonbusiness interest in Tele Danmark, and the Class A beneficial owner of the trust formed to hold the nonbusiness interest in Bell Canada. |
| Ameritech International Denmark Corp. | Holding company for part of SBC's nonbusiness interest in Tele Danmark. |
| Ameritech New Zealand Funding Corporation | Holding company that indirectly held nonbusiness foreign investments, including an interest in ADSB Telecommunications BV, the consortium that held the nonbusiness interest in Belgacom S.A. No other activity. |
| Ameritech New Zealand Investments, Inc. | Holding company that indirectly held nonbusiness foreign investments, including an interest in ADSB Telecommunications BV, the consortium that held the nonbusiness interest in Belgacom S.A. No other activity. |
| SBC International South Africa, Inc. | Holding company for part of SBC's interest in Thintana Communications LLC, the partnership through which SBC owned its nonbusiness interest in Telkom South Africa. Name change to SBC International Transatlantic Inc in 2002. |
| SBC International Taiwan, Inc. | Holding company for SBC's nonbusiness ownership interest in TransAsia Telecommunications, Inc. |
| SBC International-Societe de Radiotelephonie Ceullulaire, Inc. | Holding company for part of SBC's nonbusiness ownership interest in TRANSTEL, the entity that held an investment in the French cellular company Cegetel. |
| SBC International China, Inc. | Formed to explore telecommunications opportunities in China. Dissolved on September 6, 2001. |
| SBC International Egypt, Inc. | Formed to explore cellular business opportunities in the Arab Republic of Egypt. Dissolved on September 6, 2001. |
| SBC International Morocco, Inc. | Formed to participate in a cellular telecommunications bid in Morocco. Dissolved on September 6, 2001. |
| SBC International Turkey, Inc. | Incorporated on March 17, 2000 to participate in a cellular bid process in Turkey for a nationwide cellular license. Dissolved 18 months later on September 6, 2001. |
| SBC International Operations, Inc. | Formed to hold various nonbusiness Pacific Rim investments. |
| Southwestern Bell International Programming Corporation | Formed as part of a trust established for a telecommunications bid in New Zealand that was unsuccessful. Later made an investment in a UK cable programming venture. |
| Compagnie Generale de Videocommunication Ile-de-France, Inc. | These entities were minority partners in a nonbusiness French cable investment made in the early to mid-1990s. |
| Region Cable Cote d'Opale, Inc. | |
| Teleservice Boulogne-Sur-Mer, Inc. | |
| Teleservice Cannes, Inc. | |
| Teleservice Cote d'Azur, Inc. | |
| Teleservice Frejus, Inc. | |
| Teleservice Maures-Esterel, Inc. | |
| Teleservice Saint-Andre-Lez-Lille, Inc. | |
| Teleservice Suresnes, Inc. | |
| Teleservice Victor Hugo, Inc. | |

| Other Miscellaneous Companies | |
|---|---|
| SBC International IP Holdings, Inc. | Holding company for Bell IP Holding, LLC, a Delaware LLC, which was organized to hold an interest in the AT&T foreign trademarks after the AT&T divestiture. |

| | |
|---|---|
| **Ameritech Belgium Leasing Inc.** | This was part of an equipment leasing business operated by Ameritech prior to acquisition by SBC. The company has no payroll, but continues to hold property subject to foreign leases until the lease terms expire. |
| **Ameritech Global Link, Inc.** | Name holding company. No operations and it was dissolved 6/28/01. |
| **Sterling Commerce (EU), Inc.** | Sterling Commerce was an e-business software business with relatively minor foreign operations that SBC acquired in the 2000 tax year. FTB did not treat Sterling Commerce as unitary with SBC in 2000, but did allow combination in 2001 as a result of operational integration arising from domestic call center services and some projects to market e-business solutions to SBC's domestic customers. |
| **Sterling Commerce (Northern America), Inc.** | |
| **Sterling Commerce International, Inc.** | |
| **Vcom International 1, Inc.** | Inactive in these years, formerly a nonbusiness venture capital operation. |
| **Vcom International 2, Inc.** | Inactive in these years, formerly a nonbusiness venture capital operation. |

8

State of California
Franchise Tax Board
Legal Division MS A260
PO Box 1720
Rancho Cordova CA 95741-1720
tel: (916) 845-5741 fax: (916) 843-0580
ftb.ca.gov



Date: 06.15.10

Case: 5460198483027180
Case Unit: 5460227949595070
In reply refer to: 410:KA

BRUCE DAIGH
PRICEWATERHOUSECOOPERS LLP
400 CAPITOL MALL, SUITE 600
SACRAMENTO CA 95814-4423

| | |
|---|---|
| Regarding: | Appeal of Pacific Bell Telephone Company and Affiliates |
| Appeal Case ID No: | 521312 |
| Taxable Year(s): | 2001 and 2002 |

Dear Mr. Daigh:

Our records indicate that you are the representative in a matter currently under review by the Franchise Tax Board for Pacific Bell Telephone Company and Affiliates for taxable years ended December 31, 2001 and December 31, 2002. One of the issues under consideration is whether the taxpayer may include in its sales factor the gross receipts derived from short-term investments by the taxpayer's treasury function (the "treasury operations sales factor issue").

The Franchise Tax Board has determined that it would be in the best interests of the state and taxpayers to try to resolve this issue as expeditiously as possible rather than developing an extensive factual record in each case and pursuing the issue to its ultimate conclusion. To this end, the Franchise Tax Board proposes to allow taxpayer to enter into a closing agreement that allows the taxpayer to include in its sales factor an amount of treasury function gross receipts that will have the effect of conceding a specified percentage of the tax in issue. In return, the taxpayer would agree that the inclusion of the lower amount of receipts is dispositive of the treasury operations sales factor issue and that the issue is resolved without further right of protest, claim for refund, appeal, or litigation. The remaining issues in the matter, if any, may then proceed through the normal audit or administrative dispute resolution processes.

The scope of this program is limited. Therefore, the Franchise Tax Board is extending this offer only to taxpayers that filed a return(s) or claim(s) for refund before January 1, 2010, which included treasury function gross receipts in the sales factor(s), and who also meet at least one of the following criteria:

1. The return or claim for refund is currently under audit or is pending in administrative protest or appeal before the State Board of Equalization,
2. The return or claim for refund has been scheduled for audit but the audit has not yet commenced,

3. The return has been audited but the statute of limitations for protesting a proposed deficiency assessment arising from the treasury function gross receipts issue will not expire before August 16, 2010.

Notwithstanding any other provision of this letter, this offer does not apply to any return or claim for refund filed on or after January 1, 2010, nor does it apply to any taxpayer that was eligible to participate in a prior similar program to resolve appeals before the State Board of Equalization if the taxpayer did not participate in the prior program.

<u>The terms of the proposed resolution:</u>

The table below outlines the respective concessions of tax in issue based on including treasury function gross receipts in the taxpayer's sales factor, depending on the amount involved. The framework underlying these percentage concessions is based upon the percentage of treasury function gross receipts found to be distortive in the published opinion of the State Board of Equalization in *Appeal of Pacific Telephone*[1] (34%), as well as the percentage of gross receipts found not to be distortive in a recent unpublished opinion of the State Board of Equalization in *Appeal of Home Depot* (6.6%). The table sets forth the ranges of percentages of the treasury function gross receipts in issue as a percentage of the sales factor denominator and the amount of tax in issue that will be conceded in a closing agreement. In the closing agreement, the parties will agree that the taxpayer may include the amount of treasury function gross receipts in the sales factor denominator necessary to arrive at the percentage concessions below:

| Percentage of Treasury Function Gross Receipts in Sales Factor Denominator | Amount of Tax in Issue Conceded by Taxpayer in Closing Agreement | Amount of Tax in Issue Conceded by FTB in Closing Agreement |
|---|---|---|
| Up to 6.6% | 25% | 75% |
| More than 6.6%, up to 17.3% | 40% | 60% |
| More than 17.3%, up to 27.9% | 70% | 30% |
| More than 27.9%, up to 33.9% | 85% | 15% |
| More than 33.9%, up to 50% | 90% | 10% |
| More than 50% | 95% | 5% |

To apply the chart to the facts of your dispute, simply calculate the percentage of the sales factor denominator that is due to the treasury operations sales factor issue by dividing the taxpayer's treasury function gross receipts included in the sales factor denominator by the total sales factor denominator. For example, if the gross receipts at issue from the treasury function are $350,000 and the sales factor denominator including treasury function gross receipts is $1 million, 35 percent of the sales factor denominator is due to treasury function gross receipts. According to the chart above, the department would agree to allow the taxpayer to include in its sales factor denominator an amount of treasury function gross

[1] 78-SBE-028, May 4, 1978.

receipts that would result in a concession of 10 percent of the amount of tax at issue due to the treasury operations sales factor issue.[2] No further negotiation is required.

<u>Further limitations on the inclusion of receipts:</u>

Prior to performing the calculation set forth in the example above, the taxpayer must remove in their entirety all receipts that are, in the view of the Franchise Tax Board, derived from investments that do not give rise to gross receipts in excess of interest income, pursuant to the decision of the California Supreme Court in *General Motors v. Franchise Tax Board.*[3] In order to keep relatively simple the process of calculating the amounts removed from the sales factor denominator pursuant to *General Motors*, principal amounts received from the following types of transactions must be removed from the sales factor denominator in order to participate in this program:

a. Repurchase and reverse repurchase agreements.
b. Bank savings accounts.
c. Money market accounts.
d. Certificates of Deposit (Including Euro Dollar Time Deposits).

The taxpayer must concede 100 percent of the tax effect related to revising the amount of gross receipts to exclude the principal amounts from the above listed items. The amount reflected on the chart would then be applied only to the remaining amount of gross receipts still in dispute. For example, if the original claim for refund had a tax effect of $100,000 and the taxpayer now removes the principal amounts from repurchase agreements such that the tax effect is reduced to $60,000, the percent of concession derived from the chart will be applied only to the remaining $60,000 in dispute. The $40,000 portion of the claim for refund must be conceded in full. To determine the Franchise Tax Board's concession on the remaining claim, the taxpayer will apply the chart to the percentage of the sales factor denominator represented by the remaining gross receipts in issue.

In order to participate in this program, the taxpayer must produce adequate evidence of the gross receipts it wishes to include, as well as the types of investments giving rise to those gross receipts so that the proper removal of receipts pursuant to *General Motors*, as well as the amount properly includable under the terms of this program, can be verified.

**To participate in this streamlined resolution program, the Franchise Tax Board must receive your Participation Response (included below) by the close of business on August 16, 2010,** stating that the taxpayer wishes to resolve its treasury operations sales factor issue(s)

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[2] The concession amount will be based on the treasury function gross receipts issue only, and does not take into account any other items that may impact the taxpayer's tax liability for the tax years included in this agreement (e.g., net operating losses, credit limitations and carryover items, alternative minimum tax, or any adjustments due to intrastate apportionment).

[3] In *General Motors Corporation v. Franchise Tax Board* (2006) 39 Cal.4th 773, the Court held that the gross receipt from repurchase agreements is the interest earned rather than the total amount received, which includes the return of principal.

pursuant to this program. The response must set forth the amount of receipts in the taxpayer's sales factor that are derived from treasury activity and its calculation of the percentage and tax amount that the Franchise Tax Board would be conceding under a closing agreement. The Franchise Tax Board may ask for additional information if it is necessary to verify the calculations provided by the taxpayer.

The Franchise Tax Board will then send an abbreviated closing agreement for the taxpayer's signature. If the taxpayer has other issues pending in addition to the treasury operations sales factor issue, the closing agreement will set forth the amount of treasury function gross receipts that shall be included in the sales factor denominator pursuant to the resolution so that the tax on the other issues that remain in contention may be calculated utilizing the proper apportionment percentage. Once the closing agreement has been executed, the agreement will preclude any further action by either the taxpayer or Franchise Tax Board on the specific issue of treasury function gross receipts in the sales factor denominator for the years covered by the closing agreement.

If the taxpayer does not wish to utilize this streamlined approach, it need not respond to this letter; and may, if it chooses, continue with its audit or protest, or when appropriate, contact the Settlement Bureau of the Franchise Tax Board. If the taxpayer takes the case to the Settlement Bureau after the expiration of this offer, the resolution set forth in this letter is no longer applicable and the Settlement Bureau may choose not to extend a similar offer.

This letter is an attempt by the Franchise Tax Board to expeditiously resolve matters involving the treasury operations sales factor issue. Of course, closing agreements must comply with all applicable provisions of the Revenue and Taxation Code as well as policies and procedures of the Franchise Tax Board in order to be effective. This letter may not be construed as a concession that any amount of treasury function gross receipts is properly included in the sales factor, as that determination must be made on a case-by-case basis; nor shall it be used for any purpose other than to facilitate discussion of entering into a closing agreement on the matter referenced in this letter.

The Franchise Tax Board thanks you for your consideration of this program. Any questions should be directed to the undersigned or Carl A. Joseph, Assistant Chief Counsel, who may be contacted at (916) 845-5151.

Kathleen A. Andleman

Kathleen A. Andleman
Tax Counsel III

## PARTICIPATION RESPONSE

The taxpayer would like to participate in this program in order to allow the taxpayer to enter into a closing agreement to resolve the sales factor amounts of the treasury function gross receipts.

Taxpayer Name: ______________________________
Corporation Number: ______________________________
Tax Year(s) Ended*: ______________________________

For each tax year noted above, please provide the following information in order to expedite the closing agreement process:

**Tax Year Ended:** ____________

| Line # | | |
|---|---|---|
| 1 | **Treasury Function Gross Receipts:** Enter the amount of <u>all</u> the Treasury Function Gross Receipts. | $ ________ |
| 2 | **Sales Factor Denominator:** Enter the amount of the Sales Factor Denominator, <u>including</u> <u>all</u> of the Treasury Function Gross Receipts. Please indicate if this is from your [ ] original return, [ ] amended return, [ ] per audit findings; or [ ] other________________ | $ ________ |
| | a) Enter the principal amounts of Repurchases and/or Reverse-Repurchases improperly included as gross receipts | $ ________ |
| | b) Enter the principal amounts of Bank Savings Accounts improperly included as gross receipts | $ ________ |
| | c) Enter the principal amounts of Money Market Accounts improperly included as gross receipts | $ ________ |
| | d) Enter the principal amounts of Certificates of Deposit (including Euro Dollar Time Deposits) improperly included as gross receipts | $ ________ |
| 3 | **Total Amount of Receipts Improperly Included In the Sales Factor Denominator:** Enter the total amount of lines 2a – d. | $ ________ |
| 4 | **Revised Sales Factor Denominator:** Enter the Sales Factor Denominator, Line 2, less the total on Line 3. This number will be used to compute the Line 6 percentage and to compute the tax effect attributable to the inclusion of the Permitted Treasury Function Gross Receipts in the Sales Factor Denominator. | $ ________ |

5 **Treasury Function Gross Receipts in the Sales Factor Denominator After the Removal of Receipts Improperly Included:**
Enter the Treasury Function Gross Receipts, Line 1, less the total on Line 3. $ ____________

6 **Percentage of Treasury Function Gross Receipts in the Sales Factor Denominator**
Enter the result of Line 5 ÷ Line 4. ____________ %

7 **Percentage of Tax in Issue Conceded by Taxpayer in Closing Agreement:**
Apply the Line 6 percentage to the table included in this letter to determine the concession percentage. Report this on Line 7. ____________ %

The amounts provided above are subject to verification before applying the applicable concession amounts. Any discrepancies will be discussed with the taxpayer before the parties agree on the computations and concession amounts.

The concession amount is based on the Treasury Function Gross Receipts issue only, and does not take into account any other items that may impact the taxpayer's tax liability for the tax years included in this agreement (e.g., net operating losses, credit limitations and carryover items, alternative minimum tax, or any other adjustments due to intrastate apportionment).

In order to express your interest in participating, please return this participation response form by August 16, 2010, to the following address:

Kathleen A. Andleman
Tax Counsel III
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____________________ ____________
Signature Date

____________________
Title

**STATE BOARD OF EQUALIZATION**

Appeal Name: PACIFIC BELL TELEPHONE AND AFFILIATES

Case ID: ____________ ITEM #. B1

Date: SEPTEMBER 20, 2011 Exhibit No: ____________

TP FTB DEPT PUBLIC COMMENT