

## 2. Commercial Services

Competition for the business of commercial long distance customers is equally fierce. As demonstrated in AT&T's Waiver Petition, prompt implementation of streamlined regulation for AT&T's Commercial Long Distance Services is a logical and necessary extension of the Commission's decision in the IXC Rulemaking Order to streamline its regulation of most of AT&T's other outbound business services.<sup>34</sup>

As demonstrated in AT&T's Waiver Petition, all of the factors upon which the Commission relied to streamline its regulation of AT&T's other business services apply with equal force to AT&T's new Commercial Service classification. Commercial customers are substantial users of long distance services with the incentive and ability to evaluate all available market options.<sup>35</sup> As with their efforts regarding residential customers, AT&T's competitors have developed a

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<sup>34</sup> See AT&T Petition for Waiver of Price Cap Regulations for New Commercial Long Distance Service Classification, filed September 1, 1992 ("Waiver Petition"), which is incorporated herein by reference. Commercial Long Distance Services are defined in AT&T's proposed tariffs as domestic and international "Dial Station calls originated on a line for which the subscriber pays a rate that is described as a business or commercial rate in the applicable local exchange service tariff for switched services." See AT&T Tariff F.C.C. No. 2, Section 6.20, Transmittal No. 4308, filed July 24, 1992; AT&T Tariff F.C.C. No. 13, Section 7.1, Transmittal No. 4343, filed August 7, 1992. AT&T's Commercial Long Distance Services account for only 12 percent of the revenue generated by all AT&T Basket 1 services.

<sup>35</sup> See Waiver Petition, p. 3.

variety of offerings that directly address the needs of commercial long distance customers, such as MCI's Friends of the Firm, Preferred and Vision, Sprint's Business Clout and Clarity, Metromedia/ITT's Precision and Allnet's PaceSetter and Premier.

Commercial customers also readily switch carriers. Approximately 13 percent of Commercial Long Distance Service customers switched between AT&T and competing carriers in 1991 alone.<sup>36</sup> AT&T's share of the minutes of use by the Commercial Long Distance customer segment has fallen from 54 percent in 1987 to 39 percent in 1991.<sup>37</sup> This dramatic decline confirms that competition for the business of commercial customers is no less vigorous than that for large business customers.

### 3. International Services

International services are subject to competition as rivalrous as that for domestic services. Business and residential customers now choose from among a wide variety of competing carriers providing service to every country for which there is the slightest appreciable demand.

Accordingly, customers now have substantial choices among carriers wherever they wish to call. At least fourteen facilities-based carriers currently compete to provide

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<sup>36</sup> Id., pp. 13-14. This figure excludes changes from one AT&T competitor to another AT&T competitor.

<sup>37</sup> Id., pp. 14-15.

international service.<sup>38</sup> AT&T's competitors have negotiated operating agreements with 133 countries that account for at least 98 percent of AT&T's international minutes. MCI and Sprint provide service over their own facilities ("direct-connect" service) to countries accounting for 97 percent and 92 percent, respectively, of AT&T's international minutes. Each of the twenty-five countries that account for the greatest number of international minutes is directly served by, at a minimum, AT&T, MCI and Sprint.

Furthermore, the availability of international service for resale enables all competitors to offer virtually ubiquitous worldwide coverage. For example, AT&T provides direct dial service to 216 countries, MCI to 215 countries, and Sprint to 218 countries.<sup>39</sup> Resale similarly enables non-

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<sup>38</sup> These carriers are AT&T, MCI, Sprint, Allnet, TRT/FTC Communications Corp., Washington International Teleport, Cable & Wireless, Metromedia ITT, World Communications, International Telecommunications Corp., LDDS Communications, Atlantic Tele-Network Pacific Gateway Exchange and Telefonica Larga Distancia de Puerto Rico.

<sup>39</sup> When operator-assisted service is included, AT&T provides service to 227 countries, MCI to 226, and Sprint to 224. This breadth of coverage is reflected in these carriers' own public descriptions of their services. MCI's 1991 Annual Report (p. 20), for example, states that it has "solid relationships with all of the world's telecommunications administrations," that it provides "seamless service worldwide," and that "all of [its] key products are international in scope." Similarly, Sprint's 1991 Annual Report (p. i) states that it "serves 100 percent of the world's direct dial countries," that it is a "leading supplier of worldwide messaging services and systems," and that it "operates the world's largest public data network."

facilities-based carriers, or carriers without operating agreements, themselves to provide the same broad scope of service, and there are now at least 164 resellers competing in this market segment. Consequently, every customer of international service chooses from among a wide variety of alternatives in selecting carriers and services.

Moreover, the excess capacity in international facilities is substantial and growing. AT&T currently has only 43 percent of the available international cable system capacity emanating from the United States. As a result of the planned construction of additional cable facilities, the total cable system capacity available to all carriers will increase by four times over the next four years -- substantially more than is necessary to ensure that all customers continue to have abundant competitive alternatives. With respect to satellite capacity, AT&T's satellite leases from Comsat represent only 52 percent of Comsat's total lease revenues, and the conversion to digital satellite capacity, now almost complete, will similarly permit a 400 percent increase in the satellite capacity of AT&T's competitors.<sup>40</sup>

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<sup>40</sup> In addition, recent actions by the Commission and by the Intersessional Working Party of the INTELSAT Assembly of Parties is resulting in even further expansion of available satellite capacity. In April 1992, the Commission announced that it will phase out the limitation on separate (i.e., non-INTELSAT) satellite systems providing circuits for switched international services that interconnect with public switched networks, and at the outset is allowing each such system to provide up to 100 64-kilobit-per-second bearer circuits. See Permissible Services of U.S. Licensed International

The ability of AT&T's competitors to absorb substantial additional international traffic, and its effect on the competitiveness of this market segment, are further demonstrated by long distance carriers' aggressive and successful efforts to attract customers. International service enjoys the same multiplicity of discount offerings that characterizes domestic service. MCI's offerings, for example, include Around the World (offering reduced rates to 53 countries), Call Europe, Call Pacific, and Call South and Central America, as well as similar plans for calling to Canada, Mexico, Israel, and India. Sprint offers a variety of "Sprint World" plans to the same areas.<sup>41</sup>

The robust competition in this market segment is reflected in the rapid decline in AT&T's market share. In 1989, AT&T's share of minutes for commercial international

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Communications Satellite Systems Separate from the International Telecommunications Satellite Organization, FCC Rcd. 2313 (1992). The Working Party has now recommended to the November 1992 Assembly that it further authorize up to 1250 64-kilobit-per-second bearer circuits per satellite. Each such circuit can be made through digital circuit multiplication technology to carry five times its bearer capacity.

<sup>41</sup> Moreover, both MCI and Sprint offer an extensive range of commercial plans that integrate domestic and international services, such as MCI Preferred and Vision, and Sprint's Clarity. MCI also offers its International Optimizer feature, which provides discounts for calls to the customer's most frequently-called country. Sprint likewise offers an International Calling Option which discounts calls to as many as 43 countries.

long distance service was 65 percent; by the first quarter of 1992, it had fallen to 53 percent. During the same period, AT&T's share of minutes for residential international long distance service fell from 85 percent to 77 percent.

The Commission has recognized the competitive dynamics of international service. In its IXC Rulemaking NPRM, for example, the Commission noted that AT&T's competitors now have the ability "to compete broadly with AT&T in the provision of IMTS,"<sup>42</sup> and proposed streamlining these services as of January 1, 1993. As the foregoing evidence demonstrates, any further delay would be entirely unwarranted. The international market segment is functioning exactly as a competitive market should -- barriers have fallen, numerous competitors have entered, customers face an array of service choices, and carriers are vigorously contending to win their business. Under these circumstances, there is no need for price cap regulation of any AT&T international service.

#### 4. Operator Services

Competition in the provision of operator services has grown similarly intense, with a flood of new entrants.<sup>43</sup>

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42 IXC Rulemaking NPRM, 5 FCC Rcd. at 2645 (1990).

43 "Operator services" includes "dial O" calls involving a human operator, as well as calls that are processed automatically through network equipment.

According to the most recent Commission report, there are now 424 operator service providers competing to win customers.<sup>44</sup>

Moreover, recent actions by the courts, the Commission, and Congress have further strengthened competition and ensure that all carriers can fully compete on an equal basis in the provision of operator services. First, all interexchange carriers are now given the same access to the billing and validation data for LEC cards as is AT&T. All carriers therefore now have the ability to bill calls made with most LEC calling cards.<sup>45</sup>

Second, O+ calls from LEC payphones are no longer automatically routed to AT&T. The ballot and presubscription procedure for public telephones ordered by the District Court and the Commission has now been completed, and public telephones are now assigned to carriers through an intensely competitive process in which numerous providers successfully participate.<sup>46</sup>

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<sup>44</sup> Revised Long Distance Carrier Locator, Industry Analysis Division, FCC, Dec. 6, 1991.

<sup>45</sup> See In the Matter of Policies and Rules Concerning LEC Validation and Billing Information for Joint Use Calling Card Cards, 7 FCC Rcd. 3528 (1992); United States v. Western Electric, 698 F. Supp. 348, 355 (D.D.C. 1988); United States v. GTE Corp., Memorandum, Civ. Action No. 83-1298 (D.D.C. Dec. 23, 1988).

<sup>46</sup> See, e.g., United States v. Western Electric, 698 F. Supp. 348, 368-69 (D.D.C. 1988); In the Matter of Pay Telephone Presubscription, 4 FCC Rcd. 2782 (1989).

Third, with the enactment of the Telephone Operator Consumer Services Improvement Act ("TOCSIA"), 47 U.S.C. § 226, and subsequent Commission action,<sup>47</sup> consumers must be given both the information they need to make informed choices among providers and the opportunity to exercise those choices. Operator service providers are now required to identify themselves at the beginning of every call, to permit customers then to terminate the call at no charge, and to make available immediately upon customer request all relevant information about their rates. Further, aggregators are required to post signs identifying the presubscribed carrier, and to unblock access codes, allowing customers to access any carrier they wish from any aggregator telephone.

The intense competition in this market segment is reflected in AT&T's falling market share. In the first quarter of 1987, AT&T's share of interlata operator service minutes was approximately 84 percent. By the first quarter of 1992, its share had fallen approximately 16 percent. The drop in AT&T's share of calling card minutes has been similarly significant. AT&T's share of minutes of use for interstate calling card calls (including both calls made with an AT&T card and calls that are made with a LEC card over the AT&T network) declined from about three-quarters in the first

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<sup>47</sup> See Policies and Rules Concerning Operator Service Access and Pay Telephone Compensation, 6 FCC Rcd. 4736 (1991); Policies and Rules Concerning Operator Service Providers, 6 FCC Rcd. 2744 (1991).

quarter of 1987 to less than two-thirds in the first quarter of 1992. The share of interstate calling card minutes attributable to the AT&T card alone (i.e., excluding calls using the AT&T network but made with a LEC card) was only about 35 percent. Numerous carriers have now issued calling cards to customers (more than 100 million altogether) and are marketing them vigorously; as of the end of 1991, only 22 percent of those cards were AT&T cards. Many operator service providers have also entered into arrangements enabling them to accept bank and other commercial credit cards for calls that they carry.

The robust competition for the provision of operator services guarantees consumers the power to choose from among the numerous competing carriers, and renders the imposition of special rules targeted to AT&T alone impossible to justify. The Commission should therefore remove operator services from price caps, as it should each of the other services within Basket 1.

**II. IF THE COMMISSION EXTENDS THE TRANSITIONAL PERIOD OF PRICE CAP REGULATION OF AT&T'S SERVICES, IT SHOULD IMMEDIATELY STREAMLINE THAT REGULATION**

The second issue of the NOI requests comments on possible changes to the price cap formulas.<sup>48</sup> As demonstrated above, the pervasive competition facing all of AT&T's services renders continued price cap regulation

<sup>48</sup> NOI, ¶ 33, Issue 2.

unnecessary and denies consumers the full benefits of competition. However, if price cap regulation is extended in any fashion for a further transition period, the transition should be for the shortest possible time and the Commission should immediately streamline that regulation to the fullest extent.<sup>49</sup>

Additional streamlining will provide substantial benefits to consumers. The Commission recognized in its IXC Rulemaking Order that failure to eliminate price caps and implement streamlined regulation where feasible would impose significant costs on consumers "by delaying the availability of new services and price reductions."<sup>50</sup> Beyond the direct costs of delayed price changes and new service offerings caused by unnecessary regulations, the Commission identified several significant indirect costs of unnecessary regulation, including denying customers full AT&T "pricing flexibility needed to react to market conditions and customer demands" (IXC Rulemaking Order, ¶ 80); creating "regulatory delays and uncertainty [which] reduce the value of AT&T's service offerings" (id.); permitting "competitors as much as ninety days advance notice (more if the tariff is suspended) of AT&T price and service changes" which

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<sup>49</sup> The changes discussed in this Part II are not changes to the price cap formulas per se, but changes to the implementing regulations.

<sup>50</sup> IXC Rulemaking Order, ¶ 78.

"reduce[s] incentives for AT&T's competitors to 'stay on their competitive toes'" (id.); and negating "AT&T's ability to take advantage, as its competitors can, of being a 'first-mover' in the market," thereby "lessen[ing] AT&T's incentive to initiate pro-consumer price and service changes" (id.). In order to avoid these costs, the Commission eliminated price caps and streamlined its regulation of most of AT&T's outbound commercial services.

For the same reasons, and in the event price cap regulation continues as to some services, the Commission should streamline that regulation. Immediate streamlining should:

- o eliminate the unnecessary and harmful requirement that AT&T report interstate earnings;
- o permit AT&T to introduce tariffs on 14 days' notice with a presumption of lawfulness;
- o eliminate service band price floors;
- o give AT&T price cap credit for price reductions offered in promotions;
- o redefine so-called "new" services under the price cap rules; and
- o eliminate unnecessary regulation of such "new" services.

These proposals are discussed in turn below. Moreover, any additional transitional period of price cap regulation should be as brief as possible, certainly no more than one

year.<sup>51</sup> After a year, price caps should be eliminated and AT&T's services should be subject only to the same regulations that apply to AT&T's competitors.

Eliminate The Interstate Earnings Reporting Requirements. With the initiation of AT&T price cap regulation, AT&T's rates were no longer regulated on the basis of AT&T's "earnings" or "rate of return."<sup>52</sup> Instead, price caps control prices directly, without regard to earnings. This approach provides greater incentive for efficiency because AT&T is "able to retain the higher profits generated by its improved performance."<sup>53</sup> In its Price Cap Reconsideration Order, the Commission thus characterized the "elimination of the rate of return ceiling on AT&T's profits" as "essential to the implementation of a price cap regime."<sup>54</sup> But despite this "essential" element,

51 Issue 1 of the NOI requests comments on the next review period. NOI, ¶ 33, Issue 1. Any party seeking to continue price cap regulation beyond this final transition period should have to establish that a performance review is appropriate and should have to overcome the presumption that price cap regulation of AT&T no longer served the public interest.

52 The Commission recently observed: "we have removed AT&T entirely from rate of return regulation." In the Matter of Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Prescription and Enforcement Procedures, 7 FCC Rcd. 4688, ¶ 90 (1992).

53 NOI, ¶ 9.

54 In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, 6 FCC Rcd. 665, ¶ 111 (1991), appeal pending, AT&T v. FCC, No. 91-1178 (D.C. Cir.) ("Price Cap Reconsideration Order").

the Commission still requires AT&T to report interstate earnings. This requirement is an outmoded vestige of rate of return regulation which should be eliminated.

The reporting of earnings raises the same concerns associated with any form of rate of return regulation. The NOI describes the "limitations and drawbacks of [rate of return] regulation" as including "distorted incentives in capital investment, encouragement of cost-shifting . . . and little incentive to introduce new and innovative services" when there is a threat that a higher return will lead to price adjustments.<sup>55</sup> The current reporting requirements perpetuate all the worst aspects of rate of return regulation and undercut the incentives to greater efficiency and innovation that are the hallmark of the Commission's regulatory reform.<sup>56</sup> See infra, Part III.C.

The NTIA recognized the harms of earnings reporting in its 1987 report advocating price cap regulation, concluding that there should be only an initial

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55 NOI, ¶ 3.

56 The academic literature confirms that even the threat of price cap formula changes based on reported earnings will reintroduce the harmful effects associated with rate of return regulation. Professors Hillman and Braeutigam, for example, discuss at length distortions produced by continued earnings reporting requirements in a price cap regulatory structure. Jordan J. Hillman and Ronald Braeutigam, *Price Level Regulation For Diversified Public Utilities*, pp. 73-78 (1989). See also P. Joskow and R. Schmalensee, *Incentive Regulation For Electric Utilities*, 1986 *Yale J. on Regul.* 1 (1986).

"one-time review" in which earnings and other performance factors would be considered.<sup>57</sup> The NTIA cautioned, however, that the purpose of such a one-time review was only to determine that price caps had "generally worked as planned"; expected changes in earnings should not be a basis for adjustments in a performance review. See also infra, Parts III.B and III.C.

In all events, the earnings reporting requirement is truly superfluous in light of the competitive pressures on AT&T which ensure reasonable rates. The "belt-and-suspenders" regulatory requirements of price caps and earnings reporting are clearly no longer appropriate for AT&T.

Streamlined Advance Tariff Review. As the Commission recognized in its IXC Rulemaking Order, unlawful tariffs are extremely rare in a competitive market.<sup>58</sup> Moreover, in the event an unlawful tariff is filed, effective remedial action can always be taken after the tariff becomes effective.<sup>59</sup>

In view of the intense competition for all of AT&T's services, the Commission should immediately extend to AT&T's remaining price capped services the same limited 14-

<sup>57</sup> National Telecommunications Information Administration, Docket 61091-6191, Report at 67-68 (July 1987).

<sup>58</sup> IXC Rulemaking Order, ¶ 73.

<sup>59</sup> Id. Complaint procedures would still be available for parties seeking remedial action.

day advance review and presumption of lawfulness that apply to AT&T's other services. This streamlining of unnecessary regulations would: (i) reduce delays and costs in the introduction of tariff changes; and (ii) reduce uncertainty for AT&T and its customers concerning the implementation of proposed tariff changes.

The needless costs of the lengthy and burdensome advance review process are demonstrated by the fact that, during the three years of price cap regulation, the Commission has not rejected a single Basket 1 AT&T tariff. Yet, AT&T's ability to offer modified tariff terms to its customers has been burdened by dozens of petitions filed by competitors seeking rejection of those tariffs. AT&T's customers suffered from the delay and uncertainty caused by the attempts of AT&T's competitors to gain competitive advantage through the misuse of regulatory procedures. To reduce these costs and discourage frivolous petitions, AT&T's tariff changes should be given a presumption of lawfulness and be effective on minimal advance review.

Elimination of Service Band Floors. Price floors unquestionably deny consumers the full benefits of vigorous competition. There was never a need for the price cap restrictions on price reductions by AT&T, and certainly none exists today. The alleged purpose of price floors was to

ensure that AT&T did not price its products predatorily.<sup>60</sup> This additional layer of competitive "protection" is completely unnecessary in the face of today's pervasive interexchange competition, which eliminates even any theoretical incentive for predatory pricing. As the Supreme Court has recognized, predatory pricing is virtually never rational behavior because competition will not permit a firm to recover the losses from predation by means of subsequent supra-competitive prices.<sup>61</sup>

This conclusion applies fully to interexchange services. The Commission's findings in Docket 90-132 and subsequent developments establish that AT&T's competitors have ample excess capacity to deliver any interexchange service. See supra, Part I. In a market where substantial price reductions are common, price floors at most serve only to prevent AT&T from responding to lower competitive offerings. In these circumstances, consumers are the real losers.

Give AT&T Credit For Promotional Price Reductions.

Pursuant to the Commission's Price Cap Reconsideration Order, AT&T does not receive price cap credit for price

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<sup>60</sup> See In the Matter of Policy and Rules Concerning Rates For Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, CC Docket No 87-313, 4 FCC Rcd. 2873, ¶ 387, released April 17, 1989 ("AT&T Price Cap Order").

<sup>61</sup> Matsushita Elect. Industr. Co., Ltd. v. Zenith Radio Corp., 475 U.S. 574 (1986).

reductions that are offered to customers through promotions.<sup>62</sup> Such price reductions play a significant role in the competitive interexchange marketplace. Under price cap regulation, AT&T has reduced interstate prices by millions of dollars, but did not receive any price cap credit.

In order to ensure that the price cap formula better captures the actual prices that AT&T's customers pay, the Commission should credit and not ignore promotional price reductions. There is no rational basis for treating "promotions" differently from other AT&T price reductions. They are just as real as price reductions implemented through permanent tariff changes; consumers pay less and AT&T receives less revenue. Moreover, modifying the Commission's Rules to give price cap credit for promotional price reductions would provide additional incentives for AT&T to increase promotional price reductions and thus to reduce the effective prices for its services.

Redefine "New" Services. The Commission's current classification of "new services" under price cap regulation is both confusing and arbitrary. Under the Commission's current Rules, any price reduction that is a new pricing

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<sup>62</sup> Price Cap Reconsideration Order. AT&T has appealed that ruling. AT&T v. FCC, No. 91-1178 (D.C. Cir.). The modified treatment of promotions sought in these Comments would serve the public interest and should be implemented by the Commission regardless of whether the Court of Appeals mandates such relief.

option for consumers is treated as a "new" service for which AT&T does not receive price cap credit.

The current "new" service classification provides counterproductive incentives for AT&T not to increase the pricing options available to consumers. AT&T is thus encouraged either not to introduce "new" pricing options, or to offer options only as replacements for existing pricing options in order to have them classified as service "restructures" (for which AT&T does receive price cap credit). Customers suffer when price options based on market forces are contorted to meet artificial regulatory criteria such as those which define "restructured" services under the current price cap rules.

To eliminate this distortion of market incentives, the Commission should modify its definitions of new and restructured services for AT&T. A "restructured" service should be any service which offers the same functionalities and capabilities to consumers as existing services. A service which in fact is a further option for providing discounts should be treated accordingly: as a price change that immediately is reflected in the price cap indices. "New" services should be limited to those services which truly offer new functionalities or capabilities to consumers (or offer new combinations of capabilities).<sup>63</sup>

<sup>63</sup> Under this approach, AT&T's EasyReach Service would have qualified as a "new" service. The Commission recently considered a similar proposal in its review of

Facilitate the Introduction of New Services. The Commission should also eliminate some of the regulatory roadblocks which discourage the introduction of "new" AT&T services.<sup>64</sup> Current price cap rules delay the introduction of new services by at least 45 days, require new services to pass a three-year net revenue test, and require extensive revenue reporting.<sup>65</sup> The stated purpose of these burdensome requirements is to prevent AT&T from pricing its new services predatorily. In today's competitive marketplace, however, these rules serve only to increase AT&T's costs,

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the new services definition for LECs. See In the Matter of Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 89-79, CC Docket No. 87-313, FCC 92-325 (released August 6, 1992). The Commission chose not to adopt a "new functionality" definition for new LEC services because the parties did not explain how the Commission could distinguish truly new LEC services from services that were pricing options. Id., ¶ 6. AT&T proposes, however, that any doubt about classification of an offering as a "truly new" service could be resolved by also defining new services with reference to the statutory "like services" test. See 47 U.S.C. § 202. A service "like" an existing capped Basket 1 service would be considered a restructure.

64 Moreover, "new" services that offer new capabilities to consumers should not be subject to price cap regulation at all. Assuming arguendo that the Commission continues some form of price cap regulation for Basket 1 services despite the resulting harms to consumers, there is no reason to magnify those harms by subjecting innovative new services to burdensome regulations.

65 See 47 C.F.R. § 61.49(g).

discourage the introduction of new services, reveal AT&T's revenue projections to competitors, and prevent AT&T from offering lower prices to consumers. Just as with price floors discussed above, there is no risk of predatory pricing to justify these requirements. If a competitor or anyone else believes that AT&T has acted unlawfully in introducing a new service, the statutory complaint procedures will always be available to redress such concerns.

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If the Commission were to extend price cap regulation for a final one-year transition period, these changes to streamline regulation of AT&T's services should be made immediately. After a year, the Commission should eliminate all regulations which treat AT&T differently from its competitors. Continued asymmetric regulation severely distorts marketplace competition. By applying more stringent regulation to AT&T than to other interexchange carriers, the Commission relieves those carriers of the full measure of competitive pressure to improve their own responsiveness to customer demand. As long as any regulatory difference persists, AT&T will be handicapped, competition distorted and consumers denied the full benefits of competition.

**III. AT&T'S PERFORMANCE UNDER PRICE CAP REGULATION PROVIDES  
NO BASIS FOR EITHER AN INCREASE IN THE PRODUCTIVITY  
FACTOR OR A "ONE-TIME" INDEX DECREASE**

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The third issue of the NOI requests comment regarding whether "the productivity factor used to compute the AT&T price cap indices [should] be changed" or, alternatively, whether "a one-time change in AT&T's price cap index [should] be required" so as "to increase the benefits to customers."<sup>66</sup> Either of these adjustments would violate the rationale and undermine the benefits of price cap regulation by reintroducing the worst features of rate of return regulation. Moreover, AT&T's performance under price cap regulation supports neither adjustment. Indeed, if any adjustment were warranted, the substantial and unanticipated consumer benefits of the price cap formulas would require a reduction in the productivity factor.

Any argument for the potential adjustments apparently would be predicated on the erroneous assumption that AT&T's profitability has been unduly high, or that the proportion of AT&T's efficiency gains accruing to consumers is insufficient. However, both the NOI and the Commission's prior price cap decisions establish that the price cap formula factors (and the absolute levels of the caps) would not be altered on this basis, at least absent compelling evidence that the factors were producing unreasonable and unanticipated results. The Commission thus explained in its

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<sup>66</sup> NOI, ¶ 33 (Issue 3).

order adopting price caps that only "unintended and unexpected results" could possibly require prospective adjustments in this review proceeding.<sup>67</sup> Additionally, the Commission stated that "[o]nly if [AT&T's rate of return] deviation from an acceptable level is substantial and persistent should changes be undertaken."<sup>68</sup> More fundamentally, the Commission has repeatedly emphasized that any adjustment would not "recreate the disincentive to further productivity gains, as under rate-of-return regulation."<sup>69</sup>

As demonstrated below, by any of these measures or otherwise, there is no legitimate basis for either of the adjustments raised by Issue 3 of the NOI.

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<sup>67</sup> AT&T Price Cap Order, ¶ 557. See also NOI, ¶ 11 (the review proceeding is designed to confirm that price caps are "functioning as intended").

<sup>68</sup> In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Further Notice of Proposed Rulemaking, 3 FCC Rcd. 3195, ¶ 474 (1988) ("Further Notice") (emphasis added); see also AT&T Price Cap Order, ¶ 561.

<sup>69</sup> Further Notice, ¶ 474; see also AT&T Price Cap Order, ¶ 560; In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786, ¶ 394 (1990) ("Second Report"). To encourage these incentives to increase efficiency, the Commission confirmed that it would not seek to recapture any higher profits achieved during the period of price cap regulation. See, e.g., Further Notice, ¶ 474 ("no retroactive payments should be exacted from the carriers for their past 'extra' productivity gains, since that would diminish the very incentive to exceed an established target").

**A. The Current Productivity Factor Dramatically Understates Consumer Benefits**

The stated reason for contemplating either of the adjustments is "to increase the benefits to customers."<sup>70</sup> But the current price cap formula already mandates tremendous benefits for consumers and, in fact, requires far greater efficiency gains of AT&T than the Commission anticipated upon the institution of price cap regulation. As the Commission notes, consumers have enjoyed the full benefits of price reductions required by the .5 percent annual Consumer Productivity Dividend ("CPD"), accounting for \$819 million in lower rates over the price cap period.<sup>71</sup> Below-caps pricing produced an additional \$742 million of benefits to consumers, yielding more than \$1.56 billion of gains altogether.<sup>72</sup>

In addition, consumers have benefited in unanticipated but equally significant ways. Most

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<sup>70</sup> NOI, ¶ 33 (Issue 3).

<sup>71</sup> See NOI, ¶ 18; NOI Update, Chart 3. In fact, the CPD should be viewed as yielding considerably greater benefits. The .5 percent annual increase was based upon the assumption that AT&T's historical efficiency gains, over the national gains, had been 2.5 percent. This figure was optimistic -- or "challenging yet achievable," NOI ¶ 7 -- and the majority of studies placed the historical differential closer to 2.3 percent. See AT&T Price Cap Order, ¶¶ 39, 200-202, 221-22. If this lower figure is employed, the CPD amounts to .7 percent annually, and the attributable consumer benefit is \$1.15 billion over the initial price cap period, rather than \$819 million.

<sup>72</sup> See NOI, ¶ 18; NOI Update, Chart 3.

importantly, consumers have received lower rates by migrating from higher to lower-priced services. Customer migration has several consequences that are not manifested in the price cap formulas. For any given quantity of total minutes provided, AT&T's revenues decrease with the substitution of lower-priced services. That is, customers pay less for the same minutes of service, even though the prices charged by AT&T for those services remains unchanged. When customers migrate in this manner, AT&T must either become less profitable or increase efficiency. These gains, which entirely accrue to consumers, are in addition to those imposed directly by price cap index changes, and are not included in the \$1.56 billion of measured consumer benefits.<sup>73</sup>

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<sup>73</sup> The Commission uses the API to calculate price decreases. See NOI, App. Chart 2. The API, however, does not reflect the price decreases realized by a consumer as it changes services (or even its mix of services). Specifically, the API locks in the initial distribution of customers among various services, and then adjusts the index only to reflect changes in particular rate elements or provision of new services. Changes in demand are manifested only in the weighing that determines the magnitude of the index change produced by the change in rate element price -- not in determining the element's overall contribution to the API. See 47 C.F.R. § 61.46.

A study by Professor Richard Schmalensee of MIT and Dr. Jeffrey Rohlfs of NERA, submitted as an attachment to these Comments, concludes that the consumer benefits attributable to customer migration far exceed those reflected in the CPD or below-caps pricing.<sup>74</sup> Their analysis shows that customers received a 2.0 percent annual decline in real prices for switched services under price caps (net of both access charge reductions and the annual historical productivity differential of 2.5 percent). The CPD accounts for .5 percent of that decrease, with the remainder divided between .6 percent attributable to below caps pricing, and .9 percent attributable to customer migration to lower priced services. The study calculates that, for switched services alone, customers received approximately \$600 million of benefit from migration.<sup>75</sup> Assuming that comparable migration occurred in non-switched services, the total migration benefit amounted to more than \$850 million.<sup>76</sup> When this gain is added to the

<sup>74</sup> See Attachment, R. Schmalensee & J. Rohlfs, Productivity Gains Resulting From Interstate Price Caps For AT&T (Sept. 3, 1992) ("Schmalensee & Rohlfs Study"). The study uses price data to estimate the consumer benefits described herein. It also uses economic measures, including economic rather than book depreciation, in estimating that AT&T's total factor productivity gains for switched services were \$1.8 billion greater from 1989 to 1991 than from 1986 to 1988. Id., pp. 5-16.

<sup>75</sup> Id., p. 24.

<sup>76</sup> The migration benefit increases to more than \$850 million based on the ratio of switched service