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VIA ECFS ***EX PARTE***

September 22, 2016

Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Re: *Special Access Rates for Price Cap Local Exchange Carriers*, WC Docket No. 05-25; *AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM-10593; *Business Data Services in an Internet Protocol Environment*, WC Docket No. 16-143

Dear Ms. Dortch:

Windstream files this letter to highlight significant flaws in CenturyLink's arguments in opposition to the Verizon-INCOMPAS joint recommendation[1] for downward adjustments to rates for TDM-based BDS.[2] The crux of CenturyLink's opposition appears to be its claim that "its cost[s] to provide legacy TDM services such as DS1s and DS3s have actually increased."[3] But this conclusion uses an inflated view of costs and completely ignores accompanying increases in revenues—which are significantly outstripping costs (even as alleged by

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1 *See* Letter from Kathleen Grillo, Verizon, and Chip Pickering, INCOMPAS, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 16-143, 05-25, at 2 (filed June 27, 2016) (proposing a one-time adjustment to rates for TDM-based BDS under price caps to account for productivity gains since the expiration of the CALLS plan and a going forward annual productivity adjustment).

2 *See* Letter from Melissa Newman, CenturyLink, to Marlene H. Dortch, Secretary, WC Docket Nos. 15-247, 05-25, RM-10593 (filed Sept. 9, 2016); Letter from Melissa Newman, CenturyLink, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 15-147, 05-25, RM-10593 (filed Aug. 12, 2016) ("CenturyLink Aug. 12 Letter"). *See also* Letter from Russell P. Hanser, Counsel to CenturyLink, Inc., Frontier Communications Corporation, FairPoint Communications, Inc., and Consolidated Communications, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 16-143, 15-247, 05-25, RM-10593 (filed Aug. 29, 2016).

3 CenturyLink Aug. 12 Letter at 2.

CenturyLink) and show that incumbent LEC BDS operations require greater Commission oversight.

I. CenturyLink data show BDS revenue increases are outstripping alleged cost increases and confirm that ILEC BDS operations are lucrative and growing.

Assuming the truth of CenturyLink's assertion that its BDS costs are increasing (which Windstream also questions below), these costs to provide a service cannot properly be considered without also considering the accompanying profit margin. Higher costs can be beneficial if they lead to even greater revenue increases; indeed, higher costs can be a sign of a growing business.[4] To assess whether this is the case for CenturyLink, Windstream compared CenturyLink's BDS revenue to its alleged BDS cost increases.

What Windstream found is that CenturyLink's own data show that the incumbent LEC's BDS revenue increases in recent years far exceed its supposed BDS cost increases. Specifically, as the table below demonstrates, from 2011 to 2015, CenturyLink's compound annual growth rate ("CAGR") for BDS revenue per circuit, at 3.7 percent, is nearly twice that of CenturyLink's BDS expense per circuit, which grew by only 2.0 percent. This differential is realized in greater profits: CenturyLink's own data demonstrates that ***<u>CenturyLink's net operating income per BDS circuit has increased by 47 percent over a four-year period</u>***—from $5,994 in 2011 to $8,807 in 2015.[5] This more balanced view of CenturyLink financial data offers further evidence in support of many parties' request for Commission action to curb excessive BDS prices.

The health of CenturyLink's BDS operations is further affirmed by CenturyLink's decision to opt into and maintain price cap regulation. If CenturyLink's annual return on BDS was less than 9.75 percent, it would make financial sense for CenturyLink to seek a waiver of the Commission's rules to return to rate-of-return regulation for its BDS offerings,[6] and provide all of its BDS-specific financials—including expenses, revenue, and net investment—on the record. CenturyLink is not taking, nor has it ever taken, such a step.

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4 BDS revenue stands to grow further for incumbent LECs even with the proposed rate reforms: As Dr. J. Scott Marcus explained in a recent filing, the price elasticity of demand for BDS is substantial, so price reductions such as the ones suggested by the Verizon-INCOMPAS proposal are likely to result in increased demand that, on the whole, increases BDS providers' gross revenues. *See* J. Scott Marcus, *Welfare Effects of Reductions in the Price of Leased Line Equivalents in the U.S.*, WIK-Consult GmbH (July 26, 2016), attached to Letter from Karen Reidy, INCOMPAS, to Tom Wheeler, Chairman, FCC, WC Docket Nos. 16-143, 15-247, 05-25, RM-10593 (filed July 28, 2016).

5 *See infra* Table 1. To estimate the total number of CenturyLink "high-capacity circuits" (i.e., BDS circuits) based on the publicly available data, Windstream divided CenturyLink's publicly available "operating expenses" by its "total operating expense per high capacity circuit." *See* CenturyLink Aug. 12 Letter at Attachment B.

6 *See* 47 C.F.R. § 61.41(d).

TABLE 1:

COMBINED WIRELINE ILEC	2011	2012	2013	2014	2015		
OPERATING REVENUE	$14,315,781,488	$13,773,186,585	$13,381,998,750	$13,152,417,196	$13,072,068,183		
OPERATING EXPENSES	$10,691,935,822	$10,234,485,856	$9,752,554,745	$9,557,679,365	$9,005,338,629		
NET OPERATING INCOME	$3,402,433,666	$3,290,190,477	$3,408,397,739	$3,447,786,471	$3,807,012,670		
OPERATING REVENUE PER HIGH CAPACITY CIRCUIT	$25,213	$26,534	$27,176	$28,857	$30,240	3.7%	CAGR
OPERATING EXPENSES PER HIGH CAPACITY CIRCUIT	$18,831	$19,717	$19,805	$20,970	$20,832	2.0%	CAGR
NET OPERATING INCOME PER HIGH CAPACITY CIRCUIT	$5,992	$6,338	$6,922	$7,565	$8,807	47%	4 YR INC

II. CenturyLink data provide an overinflated view of BDS costs.

There also is good cause to question whether network costs—even in isolation—are appropriately described by CenturyLink. CenturyLink attempts to focus the Commission on its operating expense per access line and total company operating expense per BDS circuit. These metrics reveal financial conditions that are not surprising and are believable: Of course CenturyLink, like other incumbent LECs (including Windstream), is experiencing overall line loss and reductions in the number of TDM-based BDS circuits (as customers migrate to IP).

But these metrics are not all that can or should be considered when evaluating costs even in isolation—and CenturyLink omits the rest of this story. CenturyLink does not take account of the fact that access lines can deliver more services—through handling more data and delivering multiple services such as voice and Internet access—over the same transmission facilities. Moreover, CenturyLink makes no attempt to pinpoint BDS-specific operating expenses; accordingly its metrics are largely irrelevant and misleading by significantly understating the productivity achieved through modern packet networks.

In the first instance, it would make more sense to evaluate productivity based on the data throughput capacity available, rather than number of circuits. As INCOMPAS noted in its August 24, 2016 letter, the appropriate unit for cost and productivity analyses is really per Mbps, not per circuit.[7] The IP transition has enabled purchasers of BDS to replace, for example, five to eight DS1 circuits with one 50 Mbps or 150 Mbps packet-based circuit, and has enabled use of data circuits to replace multiple voice-grade circuits. Using a per-circuit measurement, therefore, artificially suggests costs are increasing—when really this is better viewed as a sign that the

[7] *See* Letter from Karen Reidy, INCOMPAS, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 16-143, 15-247, 05-25, RM-10593, at 3 (filed Aug. 24, 2016)

number of circuits required to support business communications is decreasing.[8] Likewise, because the cost per Mbps declines as consumers purchase higher bandwidth Ethernet circuits, as compared with lower bandwidth TDM circuits, the focus on lines rather than throughput capacity also understates productivity. CenturyLink has not responded to these points.

In any event, even considering costs per circuit, BDS services are just a small portion of any incumbent LEC's overall operating expense base, because the network also supports voice service (both local and long distance), consumer broadband, and in many cases video, among other things. CenturyLink's analysis is akin to a big-box retailer trying to show that the cost of selling sneakers has increased by providing its total operating expenses per customer or its total operating expenses—including salaries, real estate, and electricity—per number of pairs of sneakers sold. The total numbers regarding business operations may or may not be accurate, but they are meaningless if one is trying to get at the actual cost of providing a specific product.

In the absence of information about BDS-specific costs, a more sensible method of analysis at least would be to take the percentage of BDS circuits to total connections and allocate total operating expenses accordingly. These data show that approximately 4.5 percent of CenturyLink's total connections are BDS circuits, and that the actual annual CenturyLink operating expense per BDS circuit has been between $785 and $937 (less than $80 per month) since 2011.[9] This is a far cry from the $19,000 to $21,000 CenturyLink cites as its annual operating expense per BDS circuit over the same period. These relatively low actual costs of BDS circuits are not surprising given that much of the network costs are sunk and the network supports both BDS and residential and business voice services and both TDM-based and IP-based services.[10] In addition, to the extent a LEC such as CenturyLink (or Windstream) incurs new incremental IP investment voluntarily, it does so where the revenue opportunity created by increased efficiency exceeds the build-out costs over the long term.[11]

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[8] *See id*.

[9] *See infra* Table 2.

[10] *See, e.g.*, Opposition of Windstream Services, LLC at 14, WC Docket No. 15-247 (filed Feb. 5, 2016) (noting that ILECs can leverage their existing network infrastructure and substantial customer base, established by their position as the historical monopolist, and that fiber networks have existed since the 1970s and are used to support both IP-based and TDM-based services).

[11] *See id*. at 9.

TABLE 2:

	2011	2012	2013	2014	2015
OPERATING EXPENSES	$10,691,935,822	$10,234,485,856	$9,752,554,745	$9,557,679,365	$9,005,338,629
VOICE ACCESS LINES REPORTED	13,046,000	11,988,000	10,920,000	10,029,000	9,179,000
TOTAL CONNECTIONS	13,613,787	12,507,082	11,412,419	10,484,774	9,611,278
PERCENT HIGH CAPACITY CIRCUITS TO TOTAL CONNECTIONS	4.2%	4.2%	4.3%	4.3%	4.5%
OPERATING EXPENSES ASSOCIATED WITH HIGH CAPACITY CIRCUITS	$445,926,094	$424,762,354	$420,799,746	$415,473,049	$405,025,111
OPERATING EXPENSE PER HIGH CAPACITY CIRCUIT	$785	$818	$855	$912	$937

III. CenturyLink's continuing BDS profits are consistent with Windstream ILEC's—and other monopolies and duopolies more generally.

The strong financial health of CenturyLink's incumbent BDS business is consistent with Windstream's own experience. As Windstream has disclosed to the Commission, its margins are significantly higher in its incumbent LEC areas—where Windstream typically uses its own last-mile connections to sell BDS at retail and wholesale—as compared to its competitive LEC areas, where it largely depends on purchasing BDS last-mile inputs from incumbents.[12] It is also consistent with what one would expect in a monopoly or duopoly: One review of cartel overcharges identified in economic studies and by courts found average overcharges of 31 to 49 percent and median overcharges of 22 to 25 percent.[13]

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12 *See* Letter from John T. Nakahata, Counsel to Windstream, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 16-143, 05-25, RM-10593, at 1 (filed July 5, 2016).

13 *See* John M. Connor and Robert H. Lande, *How High Do Cartels Raise Prices? Implications for Optimal Cartel Fines*, 80 TULANE L. REV. 513, 513 (2005). Cartel overcharges would be expected to be less than monopoly overcharges in the same industries because cartels are often incomplete.

CenturyLink dramatically mischaracterizes changes in its BDS costs, and wholly ignores the much greater increases in BDS revenues it has achieved over the past five years. With revenues increasing faster than costs, CenturyLink's net operating income for BDS is up by almost 50 percent. And CenturyLink's productivity for BDS has been growing demonstrably, with more of its services now able to be provided over fewer lines. These data provide further confirmation that imposing controls on incumbents' market power makes economic sense and will benefit consumers.

Sincerely yours,

/s/ Malena F. Barzilai

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