Second, the objective of price cap regulation is to replicate a competitive market result. The proposals advanced by WilTel and MFS are explicitly designed to enforce an outcome that no competitive market would produce. In fact, these are merely recycled versions of arguments raised repeatedly by these same parties in the Commission's earlier proceedings on switched transport and expanded interconnection.

Rates which are different across elements, services, or customers do not necessarily indicate, as commenters suggest, the presence of unreasonable discrimination. On the contrary, such rate differentials are part of a competitive market outcome. Artificial constraints which impose uniformity on rates will create efficiency losses which will harm consumers.[121]

Competitive markets do not ensure that each price represents the same markup over its respective incremental cost. In fact, economics literature makes it clear that economically efficient prices will have different markups depending on the demand characteristics of the service.[122]

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121 These losses would take two forms: 1) By providing consumers with incorrect price signals, pricing constraints would create losses in allocative efficiency. Consumers would make distorted choices of what service to buy, and how much to buy. 2) By creating price umbrellas, these constraints would lead to losses in technical efficiency, and raise overall industry costs. Firms would find it privately profitable to make investments which were socially undesirable. *See Schankerman* at 3.

122 See, *Baumol-Sidak* at 35-40. Further, the relevant demand characteristics are those faced by the individual firm in each of its markets, rather than the elasticity faced by the industry as a whole. This firm elasticity will vary depending, among other things, on the degree of competition in each market. "Ramsey markups on competitive products will be lower, because they are appropriately guided by the firm's elasticity of demand...." (*Baumol-Sidak* at 40) Therefore, rate reductions in competitive markets, which MFS labels discriminatory, are in fact an integral part of an efficient pricing outcome.

Further, prices in competitive telecommunications markets are generally not uniform. Competitive firms -- such as IXCs, CAPs, and cellular carriers -- offer a wide variety of volume discounts (tapered ProWATS rates), optional plans (Reach-Out, Friends and Family), term and volume commitments (DS1 and DS3 purchase plans), and customer-specific contracts (AT&T's Tariff 12)[123] While differences in these rates may be justified, in part, on differences in incremental cost, the market will not, in general, set them in such a way as to satisfy the proposed constant-markup rule.[124] These non-linear pricing arrangements correctly reflect the fact -- acknowledged by most commenters -- that telecommunications services are characterized by economies of scale and scope, so that incremental costs are less than average costs. By bringing prices at the margin closer to incremental cost, these arrangements improve efficiency and allow customers to respond to more accurate price signals.

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[123] For example, the record in the Commission's proceedings on interconnection and switched transport makes it clear that many competitive providers of DS1 and DS3 high-capacity services, including IXCs and CAPs, offer term and volume discounts at least as great as the LEC discounts commenters in this proceeding have labeled "discriminatory." *See*, GTE's Comments on MFS' Ex Parte Submission, Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, RM 7249, ENF-87-14, filed June 15, 1992.

[124] *Schmalensee-Taylor Reply Comments* (at 17) explain why this is so: "[P]ermitting a firm to reduce prices to retain customers or service volumes that it would otherwise lose to competitors would result in lower prices for all consumers, provided only that services were priced above incremental cost. The reason is simple: at any price above incremental cost, every sale covers its own costs and provides some amount of contribution towards the fixed common costs of the firm. Other customers and other services do not bear 'excessive and unreasonable prices' because of LEC volume or term discounts or customer-specific pricing; on the contrary, prices for other LEC services can be reduced, and price competition can be fostered in markets facing competition." *See also Baumol-Sidak* at 73: "It is easy to show that such differential prices, suitably selected, can benefit even the party that pays the higher **relative** price." (emphasis added)

On the other hand, by arbitrarily limiting these non-linear pricing arrangements, the constant-markup proposal would prevent LEC prices from reflecting the patterns observed in competitive telecommunications and other markets, and would thereby prevent the price cap plan from imitating a competitive outcome. It also would impose on LEC customers prices which are clearly inefficient. GTE's proposal would provide the safeguards needed to protect consumers, but would do so without depriving them of service choices which would make them better off.

Third, the Commission recognized, in developing the price cap plan, that traditional "cost-plus" regulation could not be relied upon to determine efficient relative price relationships. The Commission expected that, by providing limited flexibility for relative price adjustments, a price cap plan could lead to more efficient rate relationships that would be closer to those a competitive market would set.[125] The constant-markup proposal would place an artificial constraint across relative rates by imposing a new "cost-plus" rule. This would prevent the Commission from realizing the benefit of improved pricing efficiency which was one of its goals in adopting price caps.

Fourth, the ability to vary relative rates and to offer non-linear discounts, especially, are both essential to any firm's ability to compete effectively in telecommunications markets.[126] By limiting the ability of exchange carriers to set such rates, the constant-markup rule would preclude them from responding to competition.

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125 *LEC Price Cap Order*, 5 FCC Rcd at 6791.

126 In the interexchange market, for example, IXCs have competed by offering term and volume discounts, optional calling plans, and customer-specific contracts, rather than by making across-the board reductions in uniform rates. All of the benefits consumers have received from interexchange competition have therefore come through the availability of non-uniform rates.

Such a rule would therefore prevent the price cap plan from meeting its goal of promoting the development of effective competition. This, of course, is precisely the intent of the parties proposing the constant-markup rule.

Further, such a constraint would not even be effective in preventing the differences in rates that parties claim are discriminatory. As *Schmalensee-Taylor* point out:

> Since competitors are not required to serve ubiquitously at averaged rates, the competitive process will insure that well-situated customers will be offered low prices reflecting their circumstances. There is no question what prices such customers will pay; the only question is whether or not the LEC will be permitted to compete for their business. In such circumstances, it is easy to see that customers benefit from the LEC's ability to meet market prices, and limitations on that ability reduce some of the benefits from competition to which customers are entitled.[127]

The Commission came to this same conclusion in its interconnection proceeding:

> Denying the LECs flexibility...will not prevent the larger IXCs from obtaining discounts, either from CAPs or through self-supply, but will only prevent them from getting the discounts from the LECs. Thus, a ban on discounts would disadvantage the LECs without providing small IXCs the benefits they seek to achieve.[128]

Some parties further propose that the Commission should implement new requirements to prevent LECs from engaging in what are called vertical price squeezes. These commenters generally advocate an extension of the Commission's existing policy on interconnection.[129]

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[127] *See, Schmalensee-Taylor* at 12.

[128] *See*, D.91-141, Second Report and Order, FCC 93-379, released September 2, 1993, at ¶117.

[129] *See*, MFS at 8, MCI at 73.

The framework proposed by GTE protects against vertical price squeezes by the exchange carrier because it conditions streamlining of LEC pricing rules on the availability of alternative access supply in the relevant market. In applying this test, GTE's proposed rules do not consider the use of the LEC network by alternative providers, through expanded interconnection, to reach customers. Therefore, in order to a market area to be designated as a CMA, alternative providers must be able to offer service to customers representing a significant portion of the access demand in the market using their own facilities. The presence of this alternative supply will provide effective market constraints on the LECs' behavior. The LEC cannot control essential facilities if alternatives are available nor can it profitably engage in a price squeeze.[130]

The Commission has already adopted a policy which requires LECs to make available expanded interconnection. Through expanded interconnection, services provided by the LEC's central office, such as local loops, multiplexing, and local switching, are available for resale by any interconnecting access customer. The framework proposed by GTE accommodates this policy.[131] The extensions of the

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[130] In a market that meets the criteria proposed by GTE, alternative providers will have facilities in place which allow them to address a large portion of a relatively small area (such as a wire center serving area). Further, while they may not be able to reach all customers within the area, they will be able to expand their coverage significantly with relatively small extensions of their networks into the remaining area of the wire center. In choosing how to reach these additional customers, an alternative provider will choose between "making" the connection on its own network, or "buying" it by interconnecting with the LEC. Since alternative providers will have that choice, the LEC will find that the firm elasticity it faces has increased for interconnection services, as well as for its other access services. Any attempt to engage in a price squeeze will be counterproductive, since it will simply prompt the alternative carriers to extend their own networks.

[131] *USTA's Petition* anticipates that the interconnection cross-connect element will be one of the codified public policy element, and will be subject to additional oversight by the Commission.

Commission's interconnection policy proposed by commenters are beyond the scope of a price cap proceeding. In general, they are built upon the same misspecification of the relevant market discussed *supra*, since they request unbundling of elements which may be related to local dial-tone competition, but which are not relevant to competition for interstate access services.[132]

In summary: Maintaining current pricing constraints or introducing new ones, as some parties suggest, is unnecessary and inefficient. These proposals are designed to protect the competitors who advance them rather than consumers.

F. Reporting requirements for all service providers should be symmetrical, as should AT&T's treatment of access cost reductions.

With regard to reporting requirements, GTE agrees with parties submitting that it is time for the Commission to establish symmetry in reporting requirements for all industry participants.[133] Service quality and network reliability are no longer under the complete control of the LECs. If the other carriers are to provide services to customers,

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[132] Further, while the availability of interconnection can provide protection against price squeezes, reliance upon this policy tool is fraught with difficulties. *Schankerman* (at 8) lists the potential problems: 1) It would require ongoing Commission involvement in the determination of interconnection rates; 2) Risk of technical efficiency losses if the interconnection rate is set too high or too low; 3) Difficulty of establishing pricing rules, especially in the presence of nonlinear pricing, and the risk of large allocative efficiency losses if imputation rules artificially constrain the use of efficient nonlinear prices. *Schankerman* concludes: "In order to avoid these efficiency costs and implementation problems with mandated interconnection, the Commission could require that some facilities competition be present before authorising regulatory streamlining in that geographic market (*e.g.*, removal of restrictions on pricing flexibility)." This is precisely what GTE's proposal does.

[133] *See*, Ameritech at 20; BellSouth at 58; Pacific at 56-58; SWBT at 63; US WEST at 50.

then they should be required to meet the same stringent standards that the LECs maintain. The telecommunications network is becoming increasingly integrated. This means the reliability of all component parts, no matter who provides them, is vital to ensure that there is no degradation in this nation's service.

GTE concurs with SWBT (at 59) that all service providers should be required to file a description of their service areas which includes zip codes, city or county boundaries, and LEC wire centers or, at a minimum, service area maps. GTE (at 62-64) recommends that all alternative access providers should be required to submit sufficient detail to the Commission for a determination to be made of the extent of competition. The Commission has traditionally relied on the LECs to make a showing of competition – but today this is becoming an impossible task. Unless the Commission requires all providers to supply necessary information to the FCC, the Commission will never be able to make a realistic examination of the state of competition.

GTE stresses that it is not arguing for the extension of unnecessary regulation to other parties merely for the sake of symmetry. Far from taking such a position, GTE urges the Commission to eliminate unnecessary regulation wherever it exists. In this case, continued asymmetry in requiring data from LECs and not from other parties would prevent the FCC from being able to make judgments soundly based on the true competitive picture.

GTE (at 67) took the position that symmetry should prevail and AT&T should treat LEC and CAP access cost changes in a similar manner - either treat both as exogenous or neither. On reexamination, GTE believes that regulatory symmetry would be served best if the Commission eliminated the exogenous treatment of all access cost changes for AT&T. Other IXCs are not required to flow through access cost decreases whether originating with LECs or CAPs; neither should AT&T be required. The interstate marketplace is sufficiently competitive to allow AT&T to determine when, where, and how it wants to lower its rates based on decreases in access costs. Removing the asymmetric treatment of exogenous costs, would be more in line with a competitive marketplace, both interexchange and access.

In summary: To provide the Commission with a factual base on which to determine the existence of competition, there should be regulatory symmetry that requires all service providers to report on service quality and network reliability and to inform the Commission of their serving areas. Also, AT&T should treat neither LEC nor CAP access cost reductions as exogenous..

G. The timely introduction of new services at competitive rates must be allowed if competition is to flourish and consumers are to benefit.

The NPRM (at ¶73) stated that one of the primary objectives of the price cap plan is to establish incentives for LECs to become more innovative in the development and introduction of new and technologically advanced services. The Commission (at ¶79) recognized that the current rules impose unnecessary regulatory impediments to the offering of new services and limit the LECs' ability to compete with alternative providers. The Commission requested suggestions for rule changes that would allow the price cap plan to deal more effectively with new services. In particular, comment (at ¶¶81-82) was sought on the proposal that the treatment of new services should vary depending on the level of competition, and on ways to reduce cost support requirements while improving the effectiveness of regulatory review.

In its comments, GTE proposed a new framework of rules which would remove the unnecessary impediments to new services presented by the current rules.[134] This proposal has two main features:

> First, it would eliminate the current Part 69 rules in which the access rate structure is codified. The proposed rules would codify only those access rate elements that are necessary to implement a specific public policy program established by the Commission. (GTE at 40)
>
> Second, it would apply different tariff review standards to new services depending on the degree of competition in the market where the service is introduced. GTE's proposal offers specific rules for implementing the approach suggested in the NPRM. (GTE at 57-60)

GTE's proposal would establish incentives for exchange carriers to develop and introduce new services which more closely approximate those faced by a firm in a competitive market. Consumers would benefit from the increased availability of a wider range of new service options. Further, since new services are an essential part of any firm's efforts to compete, more symmetric new service rules would allow LECs to compete on a more equal footing with alternative providers. This symmetry is essential if the price cap rules are to promote allocative efficiency in customers' choices of services and providers. It also is necessary to promote technical efficiency in service provision and to ensure that investment in the NII is made efficiently.

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[134] GTE's proposals are the same as those made by USTA. *See, USTA's Petition*, Attachment 7, Parts X and Y, for specific proposed rules.

Where necessary, GTE's proposal would provide protection for consumers against any possible exercise of market power by the LECs. However, like GTE's proposals for the regulation of existing services, the proposed new service rules regulate only to the extent necessary to protect consumers, and they provide this protection at minimum cost in terms of distortion of the competitive market outcome.

Some parties, such as MCI (at 56) and MFS (at 22) citing new services which have been introduced, suggest that there is no impediment to new service introduction today that merits any reform of the Commission's rules. Instead, these parties propose still more restrictive rules which would further limit the LECs' ability to introduce new services and compete effectively. These proposals should be rejected since they do not meet the basic test of providing necessary consumer protection at minimum cost.

In fact, the current rules severely inhibit the introduction of new LEC services. This problem was recognized by the Commission in the NPRM (at ¶73) as well as in the *Staff Analysis.*[135] The rules introduce significant delay and uncertainty because of the need to seek either a waiver or change of the Part 69 rate structure rules which no competing carrier must do. The rules impose notice periods and cost justification requirements only on LECs. Other carriers, subject to streamlined regulation, can file tariff changes with a one day notice period, with no cost justification, and with a range of rates. LECs have certainly made an effort to introduce new services and have succeeded in putting several new offerings into effect during the review period. However, this experience does not justify a conclusion that reform is not needed.[136]

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135 *See, Staff Analysis* at 41.

136 *See*, for example, MFS at 26, Teleport at 12.

The new services implemented have been primarily special access services, services with limited applications, or those mandated by the Commission. The Part 69 rules have never codified special access subelements; therefore, LECs have been able to introduce new special access services without the need to waive or change the rules. This should demonstrate that codification of rate elements is not necessary to protect consumers. However, the asymmetry in the rules has created a bias in favor of special access (or dedicated alternatives from other providers) as a means of meeting customers' needs. Special access customers have a variety of options available including term and volume plans. No such alternatives are available for switched services.[137] This has distorted customers' choices between switched and special services and has created an artificial incentive for the construction of new dedicated networks. As technology makes possible a broadband, intelligent switched network capable of delivering advanced services to a wide range of customers, this asymmetric regulatory treatment will become increasingly costly to society.[138]

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137 In the interexchange market, volume and term discounts are not confined to private line services. A wide variety of discounted switched service options is also available.

138 The asymmetric treatment of switched and special services is a good example of the efficiency losses created by asymmetric regulation in general. As *Schankerman* (at 3-4) explains, asymmetry leads to a loss in allocative efficiency, because distorted prices cause consumers to purchase the wrong mix of services. It also causes technical efficiency losses by leading consumers to choose a less efficient solution to their needs -- either the wrong service, or the wrong supplier. This initial distortion can lead to large dynamic losses over time. Once consumers have chosen special access over switched, for example, they may make complementary, idiosyncratic investments based on that choice, such as the purchase of CPE or the hiring of staff to manage a private network. These customers, who might otherwise become early adopters of new switched services, may then be inhibited from doing so by their sunk investments in special arrangements. Further, subsequent investment in innovation by customers, carriers, and equipment suppliers may be misdirected, as "localized

Even when the rate structure rules are not an issue and new LEC services have not been opposed by any party, the current tariff review process introduces significant delays. For example, as GTE (at n.29) stated, GTE's MetroLan service was delayed from September 1993 until February 1994. Proposals that required waivers or rule changes, or that were opposed, have been delayed for much longer periods. It is impossible for LECs to predict the acceptance of new services with any degree of certainty. As an example, GTE filed a proposal in August 1993 for term and growth purchase options for switched access.[139] which has not yet been acted upon by the Commission.

The current rules have the perverse result that the services which are least likely to be accepted are those which are the most innovative, will be of interest to the widest range of consumers, and are the most effective in responding to competition.[140]

Not only do the rules delay proposed services by creating an expectation of delay and uncertainty, they discourage LECs from proposing new services. One measure of this effect is the availability in state tariffs of a number of services which have never been proposed at the interstate level: Asynchronous Transfer Mode, Asymmetrical Digital

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technical change" focuses on special, rather than switched, applications. (*Schankerman* at n.3.) In this way, the entire future course of development in the industry may be shifted to another less efficient path.

139 *See*, Petition for Waiver of the GTE Telephone Operating Companies, GTE Telephone Operating Companies Petition for Waiver of Part 69 of the Commission's Rules to Offer Switched Access Discount Plan, filed August 3, 1993, FCC Public Notice DA 93-977, Released August 17, 1993.

140 While Teleport (at 11) states that it is "unaware of any new LEC service that has not been offered because of price cap restrictions", MFS (at 28) says that "numerous" service proposals by LECs have been rejected by the Commission, or have been withdrawn by the LEC in the face of opposition by other parties.

Subscriber Line, digital video service, ISDN Packet Access Line, Customer Network Control Services, Multi-Media Data Services, and virtual private line services.

It is clear that the current rules do impede the introduction of new services. This problem is caused by two features of the current rules: the rigid Part 69 rate structure; and the new service pricing rules. If a new price cap plan is to achieve the Commission's goal of encouraging new services, it must be based on reform of the rules in both of these areas.

Price cap reform must introduce greater flexibility into the existing rate structure rules because these rules are the major source of delay and uncertainty surrounding the introduction of new services. It also is the greatest source of the asymmetric bias between switched and special services discussed *supra*. Streamlining the waiver process would not, by itself, fully address these problems. For example, the Commission would still face the problem of classifying new services within a structure which was designed with older technology in mind. Further, the current rate structure does not provide a reasonable basis for the structure of price cap baskets and bands. GTE's proposal provides a flexible, functional approach for defining baskets which complements the proposed reform of the Part 69 rate structure.

Some parties complain that many of the new services proposed by LECs during the review period were not "truly" new, but represented new purchase options for functions which were already available. GTE submits that the offering of new service options is of benefit to consumers whether the underlying function is new or not. This is evident in the experience of the interexchange market. IXCs have introduced some services which included new functions (*e.g.*, Software Defined Network or ISDN) and other new services which did not (*e.g.*, Reach-Out, Friends and Family, and Pro-WATS). If anything, it is likely that more customers have derived greater benefits from the availability of new IXC pricing options than from IXC services which MFS and Teleport would consider "truly" new.[141] New pricing options and packages are the vehicles through which telecommunications companies adjust their offerings to meet customers' needs and to compete effectively with other providers. They also are the means through which non-linear pricing is implemented. For the reasons discussed *supra*, this form of pricing increases efficiency and makes possible greater benefits for all consumers – even those who may not choose to purchase a discounted option. The Commission recognized this fact in establishing the original price cap plan.[142]

The current price cap rules correctly identify a new service as one which provides customers with a new option. This approach recognizes that greater choice for customers is inherently good. Further, if a service meets this definition, consumers are inherently protected against being made worse off by the continued availability of the previous options.[143] GTE recognizes that different degrees of tariff scrutiny may be appropriate for new services depending on the degree of competition in the market where the service is

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141 In fact, all of AT&T's voluntary rate reductions have come in the form of new services and pricing options, rather than as across-the-board reductions in the standard Message Telephone Service ("MTS") rates.

142 47 CFR Section 61.3 (5). This definition of new services has been represented by the Commission on numerous occasions. *See* D.87-313, Order on Reconsideration, 6 FCC Rcd 2637, 2693 (1991) (*subsequent citations omitted*): "[N]ew services [are defined as] those that expand customers' range of options.... [They] need not incorporate the use of new technology or functionality. Under our definition, an offering that is simply a re-priced version of an existing service or an added option to an existing service will be treated as 'new.'" Similarly, *see* D.87-313, Memorandum Opinion and Order on Reconsideration, 6 FCC Rcd 665, 675 (1991) (*subsequent citations omitted*).

143 If anything, the availability of older services provides a more effective check on the pricing of a new service that is not "truly" new, since they are likely to be closer substitutes for such a service.

introduced. However, the Commission should not attempt to distinguish services which are "merely" new from those which are "truly" new nor should it apply different price cap rules on that basis.

In summary: As the Commission has recognized, the current rules do impede the introduction of new services. To meet the Commission's goals, a new price cap plan must incorporate reforms to both rate structure and new service pricing rules. These reforms should apply to all services which meet the price cap definition of "new," regardless of whether or not they incorporate new functions.

H. The Commission should adopt new service pricing rules based on the adaptive framework proposed by GTE.

GTE's proposed framework of market classification provides a reasonable basis for implementing the suggestion in the NPRM (at ¶82) that the treatment of new services should vary depending on the degree of competition. Under GTE's framework, the Commission will have already established a process for determining the degree of competition in each access market. GTE's proposal would then adjust the degree of tariff scrutiny to be applied to new services, depending on the classification of the market where the service would be offered.[144]

GTE's proposal would allow consumers to benefit from a wider variety of new service choices, which could be introduced more rapidly as new technology became

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[144] *See,* GTE at 63, *USTA's Petition* at Attachment 7, Parts X and Y. Because new access services will be highly substitutable with other services in the market, it is only reasonable to evaluate the degree of competition at the level of the access market discussed *supra*, rather than for each new service individually. This approach would also relieve the Commission of having to undertake a new study of competition in response to every new service filing.

available, as customer's needs changed, or to meet competition from other providers. The Commission could achieve these gains without risk to consumers since more flexible pricing rules would be conditional on satisfying the competitive criteria established in the framework. In markets where a competitive showing has not been made, consumers would continue to be protected by appropriate floors and ceilings on new service prices.

Several commenters propose that, instead of being streamlined where competitive conditions warrant, new service pricing rules should be made more restrictive than they are today. These proposals should be rejected.

MFS (at 28), for example, proposes that new services should be subject to a "cost consistency test," which would require every new service element to recover the same proportion of overhead costs. It is wrong to apply such a "constant markup" rule to new services for the same reasons discussed *supra* that it is wrong to apply such a rule to existing rates. It would: impose a rigid relationship across new service rates that no competitive market would create; deprive consumers of attractive new service options; and prevent LECs from competing effectively. By imposing inefficient prices, it would impose losses in both allocative and technical efficiency. Therefore, instead of protecting consumers, it will make them worse off.

MFS (at 33-37) further proposes that the basis for the constant markup calculation should be Total-Service Long-Run Incremental cost ("TS-LRIC"). This measure is similar to what economists refer to as Average Incremental Cost ("AIC"). It measures the difference in the total cost of the firm caused by the provision of a service, divided by the number of units of the service provided. It is reasonable for a service as a whole to cover the sum of its AIC.[145] However, it is not reasonable for AIC to be used as the floor for individual rates as MFS suggests. Because AIC averages all of the cost associated with a service, it effectively pro-rates a portion of any fixed costs across every unit of the service sold. For example, if a LEC incurred a one-time expense for right-to-use fees for software needed for a service, an AIC standard would require every unit of the service to recover an allocation of that cost. Such a rule would establish an artificial floor under LEC rates. This would prevent LECs from offering efficient non-uniform discounts at rates that more than covered the additional cost of producing the additional units of service sold. Customers would be deprived of these attractive rates, and LECs would be unable to compete with alternative providers that were not encumbered with such a rule.[146] For services which are not sold at uniform rates (or for customer-specific contracts), the appropriate price floor is incremental cost.[147] This is the only price floor which is necessary to ensure that a more efficient rival

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145 *See*, for example, *Baumol-Sidak* at 65. AIC would then be the floor for an individual rate only in the special case where all units of a service are sold at a single, uniform rate. Of course, the intent of the cost-consistency proposal is to impose uniform rates on LEC services. Note that, in less competitive areas, GTE's proposed rules would ensure that each new service does cover its relevant cost. In a TMA, the proposal would subject a new service to a net revenue test. Any service that passes a net revenue test will cover its AIC for the service as a whole. Prices for new services in an IMA would be shown to be above incremental cost, and to be reasonable.

146 As demonstrated *supra*, efficient nonlinear rates benefit even those customers who do not purchase the service at the lower rate. As *Baumol-Sidak* (at 73) explain, even though such pricing "entails sales to one customer at a lower price relative to marginal cost than the price at which the same product is sold to another customer, such differential pricing can easily benefit both parties."

147 *See, Baumol-Sidak* at 73. Specifically, the additional revenue from the units sold at the lowest price must cover the AIC of <u>those</u> units (that is, AIC calculated over only the lowest price units as the increment, excluding fixed costs associated with the service generally). "[I]f differential pricing satisfies this variant of our rules, it cannot exclude a more efficient rival, so that the purpose of the rule is achieved."

cannot be excluded and, at the same time, that an inefficient rival cannot be protected artificially. Of course, since MFS proposes to enforce a constant markup above AIC on all elements, the effective price floor would be set even higher than AIC.

Other parties propose variations of this basic theme. WilTel, for example, correctly supports incremental cost, rather than AIC, as the rate floor, but seeks (at 22) to impose a constant-markup rule across elements similar to MFS. AT&T (at 43) proposes constant markups across pricing zones. All of these proposals suffer from the same deficiencies as the "cost-consistency" rule and should be rejected.

In another variation, both WilTel (at 22) and ICA (in Attachment B) propose schemes which "link" or "index" subsequent rate changes in new service prices to changes in rates for existing services. These proposals, like the "cost-consistency" approach, would establish an arbitrary and uneconomic constraint across relative prices. In a competitive market, there is no reason to expect that the relative rates of newer services will move in lock-step with rates for older services. In fact, the opposite is often true -- the introduction of new technology, or an increase in the demand for a new service, may reduce the cost of the new service relative to old ones.[148] The price cap plan was intended to promote efficient pricing by allowing relative prices to adjust over time.

A common feature of all of the proposals to tie, index, mark-up, or link rates is that they all are designed to increase the cost to an exchange carrier of adjusting rates to respond to competition. By forcing a LEC to move all of its rates in order to change any one

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148 Such a rule applied to computers, for example, would have required the relative price per unit of computing power to remain the same over time in mainframe computers and personal computers. This would undoubtedly have retarded the growth of the personal computer market.

rate, such a rule would make it unattractive for the LEC to respond to demand or cost changes, or to competitive challenges, in specific submarkets. As the *Schmalensee-Taylor Reply Comments* (at 17) point out: "In such a market, entrants would face little danger of price reductions initiated by the incumbent LEC, and the ability of competition to lower prices to consumers would be subverted."

These proposals also fail to recognize the uncertainty inherent in new services, and the need for the LEC to adjust the rates, terms, or features of these services in the light of market experience.[149] *Schmalensee-Taylor* (at 6) emphasize the need for a LEC "to market its services to customers by varying product characteristics (including prices) to determine the best product and price for the market. In contract bridge, a peek is worth a thousand finesses, and in marketing, observing the response of actual customers to a variety of actual products and prices is essential if the firm is to serve its customers."[150] Any tying arrangement, which requires all rates to move when a new service price is adjusted, would make it impossible for LECs to generate, and respond to, market information the same way a competitive firm does.

Proposals to include new services immediately under price caps would have a similar effect.[151] First, these proposals violate a basic principle of the price cap plan since

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[149] ICA (at B-9) makes reference to the problem of eliciting the regulated firm to disclose information it holds asymmetrically. However, in the case of new services, neither the regulator nor the firm may have a very precise estimate of the demand for a service -- they must rely on the market to generate this information. ICA fails to recognize the extent to which any firm must obtain information on a trial-and-error basis in the marketplace.

[150] *See* also *Harris* at 23-23. The unpredictability of the demand for new services, price sensitivity of customers, response of competitors, and the rate of change in technology are all factors to which the LEC must be able to respond flexibly.

[151] *See* MFS at 26, ICA at B-10.

they would require the use of forecasted demand to construct the Actual Price Index ("API") when the service is first implemented. Second, they would penalize the LEC heavily for any discrepancy between the forecast and the realized demand. As actual demand is incorporated, it could shift the API for new services substantially. This, in turn, would have tremendous leverage on other rates through the "indexing" or "linking" mechanism.[162] The effect of such a rule would be to manufacture a new, and potentially overwhelming, source of risk which LECs would face whenever they proposed a new service. This risk, which would be purely an artifact of asymmetric regulation, would have nothing to do with the ordinary market risk associated with the service. This risk would make any new service much less attractive as a business proposition.

None of these proposals are necessary to ensure that new service rates are reasonable. On the contrary, they would ensure that rates are inefficient and would reduce the benefits consumers would otherwise gain from new services. The pricing rules proposed by GTE establish floors and ceilings for new service rates that will effectively guard against any possible exercise of market power by the LEC while minimizing market distortions that would harm consumers.[163]

In summary: The Commission should adopt GTE's proposed adaptive framework as the means for implementing the NPRM's suggestion that new service standards should

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[162] Note that these proposals appear to be driven entirely by the two indexes, without taking any account of the relative magnitude of new services compared with older ones. Therefore a large percentage error in forecasting a small new service could have an effect on existing rates out of all proportion to the potential revenues of the new service.

[163] GTE shows *supra* why its proposal guards effectively against prices that are too high or too low, and against vertical price squeezes.

vary according to the degree of competition. Proposals by other parties would impose inefficient prices that would harm consumers and would inhibit effective competition.

I. The review period should be seven to ten years if the price cap plan is structured correctly.

Although commenters offer various terms for the next LEC price cap review, a price cap plan that is structured correctly, as described *supra*, does not need to be reviewed for at least seven to ten years.[154] This period of time is recommended by. *Schankerman*, who said:

> Clear and stable rules of competition are needed for a period that corresponds, at a minimum, to the economic life span of capital equipment embodying new technology, and the time needed to develop and market new services and to realize the benefits of other productivity improving activities. This is necessary to enhance the credibility of regulatory commitment, to facilitate rational investment and other long range planning by LECs and competing providers, and to allow efficiency incentives to work.[155]

SPR's Analysis (at 19) produces much the same findings as *Schankerman*:

> If the regulated carrier is to be encouraged to make profound, systemic changes, then efficiency incentives must be sustained over a period of time long enough to be reflected in capital deployment decisions and fundamental marketing decisions that give rise to efficiencies.

The importance of establishing a long review period is recognized by CSE (at 12) which notes that changes every three or four years "will encourage LECs to adopt that time horizon when considering improvements." CSE (*id.*) recognizes that the result

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[154] AT&T (at 8 n.9) suggests "four years from the implementation of changes ordered as a result of the instant review." MCI (at 81) recommends three years. Sprint (at 27) suggests five years. Ad Hoc (at 33) maintains that LEC market dominance requires a triennial review. OCCO (at 13) wants another review in two years.

[155] *See, Schankerman* at 26.

of frequent reviews "will inhibit LECs from making efficiency enhancing investments, unless they will pay off before the next price cap review." If the Commission adopts a price cap plan which addresses all of the key issues, including the "Transition Issues," then a price cap review would not be necessary for seven to ten years. However, if the Commission does not incorporate all of the key issues then a shorter review period would be necessary.

In summary: GTE recommends that the Commission structure the LEC price cap plan to accommodate all of the General, Baseline, and Transition Issues and to establish a review period of seven to ten years. However, if the Commission does not incorporate all of the key issues then a shorter review period would be necessary.

III. A PROPERLY STRUCTURED PRICE CAP PLAN WILL CONTRIBUTE TO THE ECONOMY AND ADVANCE THE BUILDING OF THE NATIONAL INFORMATION INFRASTRUCTURE.

A. LEC pricing flexibility and earnings incentives will contribute to the nation's well-being.

There is a direct link between telecommunications and economic development as clearly illustrated by *WEFA*.[156] *WEFA*'s modeling assumptions, supported by input from industry experts, show that more pricing flexibility and earnings incentives provide the LECs with greater financial incentives to increase investment and deploy technologies faster -- which prompts competitors to do the same. In turn, "telecommunications services are more intensely used in the future, increasing efficiency and quality in many processes."[157] The results of *WEFA's* analysis show gains in economic aggregates -- automobile sales, housing starts, and foreign demand for U.S. produced products increase -- comprising increased economic activity that will create more jobs in the broad services sector, manufacturing, construction, and financial services.[158]

As GTE (at 2-4) states, telecommunications has become increasingly important because the American public is relying on telecommunications to bring the workplace to the home, to eliminate distance impediments in the transfer of information, and to improve productivity overall. Telecommunications increases in importance because the

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[156] See, USTA's Comments Attachment 7, The WEFA Group, *The Economic Impact of Revising the Interstate Price Cap Formula for Local Exchange Carriers* ("*WEFA*").

[157] *Id.* at 6.

[158] *Id.* at 17.

ability to transfer, store, retrieve, and manipulate information is the basis of the "information age." Telecommunications is increasingly important both for the modern services sector and for an advanced, flexible manufacturing base in order to accommodate effective domestic and international competition. In a service economy, telecommunications improves the quality, expands the availability, increases the quantity, and reduces the cost of services. Industries such as manufacturing, banking, insurance, commodities, publishing, and health-care are relying more and more on telecommunications to improve productivity while stimulating job growth through expansion. The ability to communicate faster and more efficiently will enable the manufacturing industry to implement time-saving inventory control systems, to rapidly implement computer controls in the manufacturing process, and to keep abreast of the state of affairs of the import/export business.

The parties commenting that compete, or plan to compete, with the LECs offer many reasons for limiting efficient competition and restricting the incentives and flexibility of the LECs. AT&T (at 4) states that the "full potential benefit to the economy, to the labor market, and to customers, will not be realized unless price cap regulation succeeds in reducing interstate access charges...." As the Commission (at ¶25) notes, access charges have decreased. Further, as GTE stated *supra*, GTE reduced access charges $.7 billion during the period it was operating under price caps. Price caps regulation has succeeded in producing an environment in which access charges would be -- and have been -- reduced.

CompTel and WilTel claim that LECs pricing flexibility will benefit AT&T to the detriment of the smaller IXCs. CompTel (at 13) insists that high rates for small IXCs will stymie their growth and competition will be diminished, jobs lost, and consumers injured. WilTel (at 5) states that the Commission cannot conclude that price caps improved consumer welfare or economic development compared to rate of return regulation, but (at 10) puts forth its real concern: "[T]he LEC price cap rules were adopted without any discussion of the existence of AT&T's monopsony power."

These parties' positions are completely self-serving. It is apparent that they are seeking to limit LEC pricing flexibility to <u>their</u> benefit and not for the promotion of the economy. CompTel and WilTel are using this proceeding as a platform to argue for an access rate structure that preserves competitors, not competition – their myopic view of what benefits the economy.

In any event, as GTE has shown *supra*, the Commission cannot give WilTel and CompTel the protection they seek, simply by constraining the LECs to charge rates that differ from those a market would set. Other providers – including, ironically, WilTel and CompTel themselves – offer exactly the same sorts of discounts that they view as benefiting AT&T. Unless all carriers are constrained, as these parties recommend that LECs should be, AT&T would still be able to obtain discounted services.

GTE believes that interstate access competition is important to the economy. In fact, GTE believes genuine competition is good for the economy across the board. GTE does not support the preservation of artificial competition through the protection of inefficient competitors -- whoever they might be.

The CAPs naturally want more restrictive regulations imposed on the LECs. MFS is concerned only with its ability to vie with the LECs for customers, access and local. What better way to ensure their success than to require more and more restrictions for the LECs? It is significant that MFS operates under extremely limited regulation and can price as it sees fit whether discriminatory or not. How these