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December 7, 1994

BY HAND DELIVERY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: Notice of Ex Parte Communication in CC Docket Nos. 91-213, CC Docket No. 94-1, Bell Atlantic Transmittal No. 700

Dear Mr. Caton:

On December 7, 1994, WilTel, Inc., met with Lauren Belvin, Senior Legal Advisor to Commissioner Quello. The purpose of the meeting was to discuss points raised by WilTel in its petitions for reconsideration of Commission orders in CC Docket No. 91-213, its petition to reject Bell Atlantic Transmittal No. 700, and its comments in CC Docket No. 94-1. WilTel was represented by Richard Fruchterman, WilTel's Director of Government Affairs, and by myself.

The attached handout, titled "Pending Access Discrimination Issues," was distributed at the meeting.

I have hereby submitted two copies of this notice and attachment for each of the referenced proceedings to the Secretary, as required by the

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Commission's rules. Please return a date-stamped copy of the enclosed (copy provided).

Please contact the undersigned if you have any questions.

Respectfully submitted,

Linda L. Oliver

Linda L. Oliver
Counsel for WilTel, Inc.

Enclosures

PENDING ACCESS DISCRIMINATION ISSUES

Ex Parte Presentation of WilTel, Inc.

CC Docket No. 91-213
Bell Atlantic Transmittal No. 700
CC Docket No. 94-1

December 5, 1994

BACKGROUND

TELECOM COMPETITION REQUIRES INCREASED ATTENTION TO LEC DISCRIMINATION IN THE RECOVERY OF COMMON COSTS AND OVERHEAD

THE OVERARCHING ISSUE: LEC discrimination is the primary threat to the Commission's goal of a "network of networks" connecting consumers with many diverse service vendors. Therefore, the Commission must protect and improve the tools it will need to address this problem.

THE PUBLIC INTEREST OPPORTUNITY: If the Commission requires cost-based LEC rates, with no discrimination in favor of any party, it will advance diversity of choice for consumers. The information age should rest on a national network platform in which multiple vendors -- large and small, new entrepreneurs and former monopolists -- can use the common access "on-ramps" on a non-discriminatory basis.

THE PROBLEM: LECs are attempting to establish precedents that will limit the Commission's ability to prevent anticompetitive discrimination in the future.

-- The most transparent form of discrimination is flat *refusal to interconnect*. Although a problem, this is relatively simple to discover and prevent.

-- The more dangerous form of discrimination involves LEC *pricing*. If LECs favor larger service providers, or themselves, then smaller competitors will face difficulty serving customers even though they may in fact be more efficient providers. The direct incremental costs of telecom service today are quite low compared to fully distributed costs. Non-cost-based price discrimination can prevent efficient use of the information superhighway by multiple vendors competing to meet customer needs.

KEY DISCRIMINATION CHALLENGES FACING THE COMMISSION

1. Looking beyond the MFJ: A primary question in deciding when and how to lift interLATA restrictions on the RBOCs will be the effectiveness of regulatory tools available to prevent the RBOCs from discriminating in favor of themselves, as the Bell System did prior to divestiture.

-- RBOCs will argue that so long as they charge themselves more than incremental cost, it does not matter what they charge their competitors. However, competitive problems obviously would result if the RBOCs charged other IXCs a disproportionate share of common network costs or overhead.

-- In the intraLATA market, RBOCs have shown that given the flexibility to discriminate in pricing, they will do so. RBOCs have used access discrimination to dominate intraLATA services. Such discrimination must not be allowed to spread to the interstate market.

-- The Commission must demonstrate that it is able to identify and respond to RBOC access discrimination. Decisions the Commission makes today will set precedents for the future.

2. Video Dialtone: The Commission will be reviewing LEC video dialtone tariffs, including "the reasonableness of the proposed cost allocations and overhead loadings." However, the Commission has not yet specified how much data or what kind of showing will be satisfactory, other than to observe that it will "require a strong justification" for attempts to allocate low overheads to video.

-- To protect telephone consumers from paying for video services they do not use, the Commission will need to adopt fair principles for allocating costs -- including shared network costs and overheads -- between telephone and video.

-- Discrimination will become an even more serious problem if legislative or judicial actions expand opportunities for LECs themselves to provide video services directly to customers in their service areas.

3. <u>Access Transport</u>: The Commission recognized from the beginning of the transport restructuring proceeding that if LEC access pricing is discriminatory, it can distort both (a) opportunities for new local competition, and (b) the structure of the long distance industry for which access is the largest single cost of providing service.

-- The LECs are attempting to increase discrimination between services where they face more competition (high volume interoffice transport and special access) and those where they face no competition (tandem switched transport). The result is to disrupt competition in the long distance market by denying all participants the shared efficiencies of the common local network.

-- Discrimination can result from non-cost-based pricing or discriminatory allocation of overhead.

-- The most dangerous discrimination threat comes in the context of *non-cost-based discounts* for access, especially discounts that only certain customers qualify to receive (such as AT&T -- or in the future the RBOCs themselves).

4. <u>Future New Services</u>: The Commission will be called upon to evaluate other new LEC services in the future. If the new services test (or related price cap rules) are unsatisfactory, either by their terms or due to precedents eroding the quality of information that the Commission reviews when evaluating LEC tariffs, future telecom competition will be jeopardized.

THE COMMISSION MUST GUARD AGAINST LEC ATTEMPTS TO ESTABLISH PRECEDENTS THAT WILL PERMIT THEM TO DISCRIMINATE UNREASONABLY BOTH NOW AND IN THE FUTURE.

PENDING ACCESS DISCRIMINATION MATTERS

A. RECONSIDERATION OF INTERIM TRANSPORT RULES

B. SWITCHED ACCESS VOLUME DISCOUNTS

C. LEC PRICE CAP REVIEW

A. INTERIM TRANSPORT RECONSIDERATION

A. INTERIM TRANSPORT RECONSIDERATION

The Commission erroneously concluded that using cost to establish initial transport rates would have caused unreasonable delay. Now is the time to correct those initial rates.

Background

1. Transport Cost: WilTel asked the Commission to recognize the cost relationships between various quantities of interoffice transmission in its new transport rules, and so prevent unreasonable LEC discrimination in the recovery of overhead costs.

-- The record demonstrated that the incremental cost of LEC transmission was effectively the same for all forms of transport, because all shared the use of the same LEC plant.

-- Essentially the only transmission cost differences between TST, DS1, DS3 and higher capacities of access transport are the multiplexer costs needed to break down the network into those capacity amounts.

-- Similarly, the incremental cost of the tandem switching function in LEC switches is very small.

2. The Decision to Defer Cost Review: The Commission, however, decided to permit new transport rates to take effect without cost review.

-- The Commission concluded that while it could have "undertake[n] a cost investigation to determine a DS3-to-DS1 rate relationship before implementing a new transport rate structure and pricing plan," such an inquiry would have resulted in undue delay given the Commission's desire to replace the equal charge rule quickly.

-- The Commission therefore ordered use of benchmarked special access rates "as a reasonable starting point for new transport rates while we examine the longer term rate issues in the Further Notice [on permanent transport pricing]." [See Report and Order and Further Notice of Proposed Rulemaking, 7 FCC Rcd 7006, 7032 (1992)]

3. The Decision to Permit Discrimination to Grow: In a subsequent order the Commission put the initial transport rates under a price cap system that permits discrimination to increase.

THE NEED FOR RECONSIDERATION

Reconsideration of the Interim Plan is Justified by the Facts

-- Evidentiary hearings in the states have confirmed that LECs are imposing a disproportionate share of costs on lower capacity transport services. This discrimination is now the subject of a pending complaint before the Justice Department under the MFJ.

-- Cost data accompanying LEC transport options such as Bell Atlantic's FMS service or DTT volume discounts also reveal little material differences in direct cost among different quantities of transport transmission.

Reconsideration is Essential Under the Price Cap System

-- The interim transport rates are the starting point under the price cap system. If the initial rates contain discrimination, then they infect the lawfulness of all future transport rates.

-- This is why an evaluation of transport costs and overhead loadings should have been required before the transport rates took effect. But it is not too late to correct baseline transport rates.

-- The Commission also should reconsider its price cap treatment of transport so that non-cost-based differences between transport options cannot widen, particularly during this interim period prior to general access reform.

Reconsideration is Needed Because the RBOCs Themselves are Potentially the Largest Users of Transport if the MFJ is Eliminated

-- Failure of high capacity transport services to bear a reasonable share of costs and overhead creates a built-in advantage for the RBOCs if the MFJ is lifted.

Action Necessary

TRANSPORT RECONSIDERATION SHOULD REFLECT THE ADDITIONAL COST DATA NOW AVAILABLE

1. The Commission should take the time now to reevaluate the cost basis for the initial transport rate relationships using the more developed record before it, and correct those relationships on a going-forward basis.

2. At a minimum, the Commission should move slowly and not prejudge the transport cost issue before reviewing the information developed in state evidentiary hearings and before the Justice Department.

* The Commission should *postpone reconsideration* to review the data developed in these proceedings.

* At the least, any reconsideration order should be written so as to *include no language that appears to prejudge* the cost issue before the state and DOJ proceedings are fully considered.

3. In the meantime, while reconsideration is pending, the Commission should focus on volume and term access discounts under the new services test.

Failure to reconsider the initial transport rates under a reasonable cost standard -- and particularly cost and overhead loadings in transport rates -- would reward the LECs for past discrimination, and create the basis for unintended LEC pricing flexibility for the future.

B. SWITCHED ACCESS TRANSPORT DISCOUNTS

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The Issue:

The Commission is now facing its first LEC tariffs proposing discounts for switched interoffice transport.

LECs will be watching to see if the Commission will follow through on its commitment to require a detailed demonstration under the new services test that the discounts are justified by underlying cost.

Lax oversight of these tariffs would be tantamount to granting the LECs substantial additional pricing flexibility.

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A Caveat: WilTel does not believe that the new services test itself adequately addresses discrimination, particularly insofar as the test does not specify for the Tariff Branch how cost and overhead allocation issues should be reviewed. We contend that this should be a central issue in the current LEC price cap review proceeding.

- However, the discount tariffs at issue here fail even the current weak test.
- More fundamentally, the tariffs violate the prohibitions on discrimination in Section 202(a) of the Act.

SWITCHED ACCESS DISCOUNTS: BACKGROUND

In July the Commission ordered that careful advance review of switched access discounts is necessary so that LECs do not abuse this pricing flexibility. [Expanded Interconnection, 9 FCC Rcd 5154 (1994)]

1. The FCC Has Given the LECs Only Limited Flexibility to Implement Discounts at this Time

The FCC has found that "[p]ermitting volume and term discounts for switched transport is a substantial departure from our past practice, and must be done cautiously." [Id. at 5204, ¶ 183 (emphasis added)]

The FCC therefore has established a "higher threshold for switched transport discounts" than special access discounts to "gradually introduce LEC pricing flexibility and facilitate the initial development of competitive entry." [Id. (emphasis added)]

The FCC has refused to grant LECs broader pricing flexibility because "the LECs continue to possess substantial market power in the provision of special access and switched transport services." The Commission concluded that zone pricing and switched access discounts "under the criteria we have set" are sufficient flexibility at this time. [Id. at 5207, ¶ 195 (emphasis added)]

2. Switched Access Discounts Require a Cost Showing Under the New Services Test

- Volume discounts must be "reasonable" and "justified by underlying costs." [Expanded Interconnection, 8 FCC Rcd 7374, 7433]

- LECs must provide "extensive cost showings" [Expanded Interconnection, 9 FCC Rcd at 5206] regarding the underlying direct costs of the new offering, using the same cost methodology for all related services. [Part 69/ONA Order, 6 FCC Rcd 4524, 4531]

- LECs must justify any departures from uniform loading of overheads. [Id.]

- LECs cannot bootstrap discounted switched transport "based on pre-existing discounted special access rates." Separate cost justification for the switched access discounts is required. [Expanded Interconnection, 9 FCC Rcd at 5206, ¶ 192]

THE COMMISSION SHOULD REJECT ATTEMPTS BY LECS TO FLAUNT THESE REQUIREMENTS

Example: The Bell Atlantic Plan

Proposed Rates

-- DS3:	Discounts up to 50% for a five year term
-- DS1:	Discounts up to 30% for a five year term
-- TST:	No discounts
-- Multiple DS3:	Additional discounts in excess of DS3 levels

Failings in the Proposed Justification

Bell Atlantic has disregarded the specific requirements of the FCC's order and the Communications Act.

1. Bell Atlantic fails to provide detailed cost justification required by the new services test.

2. Bell Atlantic does not even provide overhead loadings, let alone demonstrate that those loadings are reasonable across all services.

3. Bell Atlantic justifies its discounts on the ground that they "reflect the market pricing of the special access services" -- even though the FCC has made clear that a separate cost justification is required for switched access discounts.

4. And most importantly, Bell Atlantic discriminates against TST users who will see no discount (presumably because the remain captive customers of the RBOC).

Results of the Proposed Justification

1. Bell Atlantic does not show any cost savings from term service.

2. Bell Atlantic does not show that the differences between the discounts for DS1, DS3 and DS3C volume levels are based on cost. To the contrary, Bell Atlantic's cost showing provides further evidence that even the current non-discounted rates are not cost-based.

Action Necessary

THE COMMISSION SHOULD REJECT THE BELL ATLANTIC TARIFF ON BOTH SUBSTANTIVE AND PROCEDURAL GROUNDS.

1. The Commission should demonstrate that it meant what it said in July when it ordered careful review of volume and term discounts under the new services test. That test requires "extensive cost showings" to determine whether they are "justified by underlying cost."

LEC tariffs that fail to meet these conditions, either procedurally or substantively, should be rejected.

2. In particular, the Commission should make clear that when it reviews transport discounts, it will expect LECs to demonstrate how those discounts are non-discriminatory as required by the Commission's rules and Section 202 of the Communications Act.

- Demonstrate no increase in non-cost-based discrimination *among DTT services.*

- Demonstrate no increase in non-cost-based discrimination *between TST and DTT services.*

If the Commission permits LECs to implement non-cost-based and discriminatory discounts, it will be giving them the very pricing flexibility it said was inappropriate in July when it established the standards for reviewing these discounts.

C. PRICE CAP REVIEW

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The most important task for the Commission in the price cap review proceeding is to improve the ability of the price cap system to check unreasonable discrimination.

This will require modifications to both the *new services test* and the *price cap structure itself*, with special focus on discrimination in the recovery of common costs and overhead loadings.

TODAY LEC PRICE CAPS PRINCIPALLY ADDRESS OVERALL RATE LEVEL PROBLEMS -- NOT DISCRIMINATION

Background

1. The price cap band and basket system was designed for AT&T, whose ability to discriminate is constrained by the existence of hundreds of IXC competitors, including both facilities-based carriers and resellers.

2. Price caps were simply imported into LEC regulation, without extensive consideration of why discrimination concerns are more significant in the access sphere. For example:

(a) Discrimination in access is *more damaging to competition*.

-- Access is the primary input to a product (long distance), so discrimination among purchasers of the access product materially impacts their respective ability to compete. Outside of long distance, there are virtually no industries where a monopolist provider supplies an input that constitutes approximately 40% of the cost of the final product.

-- In contrast, discrimination among customers of long distance services is less damaging to society because long distance is virtually never the principal operating cost in an industry, so such discrimination is not competitively significant. (The only exception is discrimination against those who would resell long distance services in competition with the underlying facilities carrier. Hence the disputes over whether AT&T's contract tariffs are truly available for resale.)

(b) Discrimination in access is becoming *more dangerous* because LECs (and in the future perhaps RBOCs) compete with those who depend upon access to their local loops, and for the most part other elements of the local network.

-- Insofar as flaws in price cap regulation leave RBOCs free to discriminate, they area a key reason not to modify the MFJ.

(C) Discrimination in access is becoming *more likely*.

-- First, in a fiber world an even greater amount of LEC costs relate to use of common network plant and overhead, costs that can be shifted in a discriminatory fashion. Second, in a world of incipient competition, LECS have increased incentives to discriminate against those customers with the fewest competitive alternatives.

THE COMMISSION MUST BETTER ADDRESS DISCRIMINATION UNDER LEC PRICE CAP REGULATION

1. Structural Reforms: Price cap baskets and bands alone are not sufficient to prevent discrimination. The Commission must re-assess LEC rate relationships and adopt measures such as price indexing across baskets to curb the LECs' ability to discriminate in the future.

2. The New Services Test: The current test gives the LECs broad latitude to engage in strategic and discriminatory pricing. It sets a floor to prevent predatory pricing, but does not adequately address the LECs' ability and incentive to discriminate in the recovery of network overheads:

The Commission should adopt pro-competitive pricing principles to evaluate new and restructured LEC services:

- Prospective (not historical) costs should be used.
- Direct costs for all services should be determined using a long-run incremental cost approach.
- Uniform overhead allocations across all price cap services should be required (except as justified by LECs on a case-by-case basis).
- Other common costs or subsidy amounts should be recovered on a nondiscriminatory basis across all services.
- LECs should be given additional pricing flexibility only if price indexing is in place.

Each of these principles is necessary; failure to adopt any one would leave a large loophole for discrimination.

3. Use LEC productivity gains to reduce discrimination. WilTel believes that the productivity factor should be increased to more accurately reflect LEC productivity gains, and that LECs accordingly should be required to reduce their rates. The Commission should require the LECs to use these reductions to reduce discrimination in current rates -- not give LECs the flexibility to reduce rates however they want. The latter course would only lead to a worsening of anticompetitive discrimination.

4. Sharing should be maintained.