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May 17, 1995

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

RE: Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation CC Docket No. 94-1

Dear Mr. Caton:

Pursuant to Sections 1.415 and 1.419 of the Commission's Rules, attached please find an original and 4 copies of the Reply Comments of the Ad Hoc Telecommunications Users Committee, in the above captioned matter. Please date stamp the additional copy and return it with our messenger.

If you have any questions regarding this filing, please do not hesitate to call.

Sincerely,

James S. Blaszak

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation	)	CC Docket No. 94-1

REPLY COMMENTS
OF AD HOC TELECOMMUNICATIONS
USERS COMMITTEE

The Ad Hoc Telecommunications Users Committee ("Ad Hoc") hereby replies to comments filed in the above-captioned proceeding.

I. VIDEO DIALTONE SERVICE SHOULD BE SUBJECT TO PRICE CAP REGULATION.

The Local Exchange Carriers ("LECs") unanimously argue that video dialtone service should not be subject to price cap regulation.[1] According to the LECs, video dialtone service is a competitive service and the LECs are non-dominant service providers.

[1] Comments of: The United States Telephone Association at 1 ("USTA Comments"); Comments of Southwestern Bell Telephone Company at 1 ("Southwestern Bell Comments"); Comments of Bell Atlantic at 2 ("Bell Atlantic Comments"); Comments of GTE at 7 ("GTE Comments"); NYNEX Comments at 1 ("NYNEX Comments"); Comments of US WEST at 3 ("US West Comments"); Comments of BellSouth at 2 ("BellSouth Comments").

The Commission squarely addressed the issue of whether video dialtone service should be included in price caps in its Video Dialtone Reconsideration Order.[2] The Commission correctly concluded in the Reconsideration Order that video dialtone service should be subject to price cap regulation because LECs offering video dialtone services maintain control over an essential bottleneck facility and that regulation of that common carrier platform is necessary. Video dialtone service, as envisioned by the Commission, is a common carrier service not unlike other forms of common carriage transport provided by the LECs under price cap regulation. That the LECs do not appear to embrace the common carrier model of video dialtone envisioned by the Commission, and instead desire to use their video dialtone networks to provide affiliated video programming,[3] serves only to further validate the Commission's decision to apply price cap regulation to video dialtone service.

II. THE COMMISSION SHOULD ESTABLISH A SEPARATE PRICE CAP BASKET FOR VIDEO DIALTONE SERVICE.

The Commission's principle rationale for the proposed creation of a separate "basket" for video dialtone services is the prevention of cross-subsidization. Indeed, the issue of cross-subsidization of video services by basic

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[2] Telephone Company-Cable Television Cross-Ownership Rules, FCC 94-269, at ¶¶ 200-208 (released November 7, 1994) ("Reconsideration Order").

[3] BellSouth, Pacific Bell, Southwestern Bell and GTE *ex parte* Letter (July 7, 1994); F. Dawson, "Telcos Weigh Bolting VDT Scheme for Cable," *MultiChannel News* at 1 and 67 (April 24, 1995); T. Hearn, "BellSouth Fights to Keep Cable Off Georgia VDT Trial," *MultiChannel News,* at 1 (May 1, 1995); K. Gibbons, "SBC's VOD Effort Drawing Eyes to Texas," *Multichannel News*, at 3 (May 1, 1995).

telephony services has been a fundamental concern since the inception of the video dialtone concept. As discussed in Ad Hoc's Initial Comments in this docket, to implement video dialtone services, LECs will undertake massive upgrades and rebuilds of their existing networks.[4] While largely unnecessary for the continued provision of *non-video* services, substantial portions of the cost of these new facilities are likely to be charged to conventional services by virtue of self-serving LEC decisions to *utilize* the new plant for the ongoing provision of largely monopolistic voice and narrowband services.[5] Moreover, as we also observed, it is likely that LECs will be confronted with the need to maintain very aggressive pricing for retail video services (including programming) in order to compete with incumbent cable operators, presenting a strong incentive to keep the price of the underlying video dialtone service as low as possible. For these reasons, the separation of video dialtone into its own basket would clearly be in the public interest and therefore should be strongly supported.

At least one LEC, however, argues against the separation of video dialtone into its own basket. BellSouth contends that video dialtone service should be combined, for regulatory purposes, with other transport services, ostensibly to prevent a "loss of economic efficiency."[6] It is hard to envision just what economic

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[4] Initial Comments of the Ad Hoc Telecommunications User Committee at 6 ("Ad Hoc Comments").

[5] Under the Commission's "new services" rules, and as further reiterated in its approval of New Jersey Bell's Section 214 application for video dialtone service, the examination of costs and cost attribution to video services is part of the tariff review process. New Jersey Bell Telephone Company, FCC 94-180, at ¶ 43 (released July 18, 1994). While no explicit "assignment" of common network costs to existing, conventional services is *per se* required under price caps, there is an *implicit* assignment of such costs that occurs residually when new video services are being tariffed for the first time, since whatever costs are *not* assigned to the new services are effectively assigned to, and borne by, conventional services and their users.

[6] BellSouth Comments at 5-6.

efficiencies BellSouth is referring to; but even assuming that some level of economic efficiencies may be lost as a result of the creation of a separate basket for video dialtone services, the opportunity for cross-subsidization and the resulting harm to the public interest that would result from inclusion of video dialtone with other transport services would far outweigh any such potential loss. While pockets of competitive activity exist in the transport market, the LECs possess abundant market power in the transport market now and into the foreseeable future. If video dialtone service is combined in the same basket with transport services, the LECs' will be able to readily fund subsidized pricing in the video dialtone market through offsetting rate increases in the prices of transport services.

Interestingly, however, most LECs have endorsed a separate basket for video dialtone services.[7] While the LECs' may support a separate video dialtone basket to facilitate the early removal of video dialtone services from price cap regulation, the effect -- which as US West puts it is, "to wall off VDT services"[8] -- is clearly desirable (particularly in conjunction with Ad Hoc's other recommendations)[9] because it diminishes the LECs' ability to cross-subsidize VDT services.

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[7] Southwestern Bell Comments at 3-4; NYNEX Comments at 4; US WEST Comments at 12; GTE Comments at 17.

[8] US WEST Comments at 12-13.

[9] Ad Hoc Comments at 14-19.

III. THE PRODUCTIVITY OFFSET FOR THE VIDEO DIALTONE BASKET SHOULD BE SET AT ZERO; AND THE PRODUCTIVITY FACTOR THAT APPLIES TO OTHER (NON-VIDEO) PRICE CAP BASKETS SHOULD INCREASE COMMENSURATELY.

Most LECs as well as other parties have endorsed setting the productivity offset for the video dialtone basket at zero. However, most fail to discuss, in this context, the Commission's explicit question at paragraph 16 of the Further Notice of Proposed Rulemaking in this docket (released February 15, 1995) ("FNPRM"), of whether other adjustments, particularly changes in the productivity factors that apply to other price cap baskets, might be needed to offset the separation of video dialtone into its own basket.[10]

As discussed in Ad Hoc's Initial Comments, the separation of video dialtone and other new broadband distribution services into their own price cap basket, while clearly necessary, is not by itself *sufficient* to assure that the Commission's objectives for price cap regulation are fully satisfied.[11] In particular, and consistent with the Commission's discussion in paragraphs 14-16 of the FNPRM, the creation of a separate video dialtone basket is not sufficient unless that action is coupled with an appropriate disaggregation of the composite X-Factor itself.

Ad Hoc has discussed the merits of, and sound rationale for, adoption of a policy in which the average X-Factor adopted in the price cap review is disaggregated, with the VDT basket X-Factor being set equal to zero and the non-video X-Factor being set at a higher level, such that the average is held

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[10] NYNEX does respond to this question, but argues that there is no need for any adjustments to other price cap baskets. NYNEX states that VDT is a still a nascent service and there are no historical data to estimate any potential effects of VDT on access productivity. NYNEX Comments at 7.

[11] Ad Hoc Comments at 11.

constant.[12] Such a policy is critical to the achievement of the Commission's objective to prevent cross-subsidization of video dialtone services.

On May 9, 1995, the price cap LECs, in their respective compliance filings required by the Commission's First Report and Order in this docket (released April 7, 1995) ("First Report & Order"), made their election from the three alternative X-Factor and sharing options that the Commission specified in the First Report & Order. Five of the seven RBHCs, Sprint, and a number of the GTE operating companies elected the maximum 5.3% X Factor with no sharing or earnings cap.[13] If video dialtone services were to be split off into a separate basket with an X-Factor of 0 without changing the X-Factor applicable to the non-video baskets, the effect would be a net decrease in the *average* X-Factor applicable for the LEC. However, there is no provision in the First Report & Order for any net decrease in the *average* X-Factor as elected by each respective LEC. Accordingly, Ad Hoc believes that the First Report & Order effectively *requires* an offsetting increase in the X-Factor for the non-video dialtone baskets so as to maintain the overall average at the elected level.

IV. COSTS AND REVENUES ASSOCIATED WITH VIDEO DIALTONE SHOULD NOT BE CONSIDERED IN CALCULATING THE LEC'S INTERSTATE RATE OF RETURN.

LECs that are subject to sharing and to low-end adjustments should not be permitted to combine their video dialtone/broadband earnings results with those for conventional voice/narrowband services in calculating the composite rate of

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[12] *Id.* at 14.

[13] The five RBHCs electing 5.3% were Ameritech, Bell Atlantic, BellSouth, Pacific Telesis, and Southwestern Bell.

return. The consolidation of the video and narrowband earnings into company-wide composites would depress overall LEC earnings, enabling LECs to avoid sharing obligations, and effectively diverting these funds from telephone ratepayers to the LECs' video/broadband ventures.[14] Even LECs who have chosen to operate under a 5.3% X-Factor should not have been allowed to combine video dialtone and narrowband results because combined results would almost certainly understate the LECs' narrowband performance and mitigate against further increases in the X-Factor. The LECs' video dialtone operating results should not pollute the carriers' narrowband operating results.

The reasons offered by LECs for combining video dialtone and narrowband costs and revenues, *e.g.*, uniformity in composite results[15] and reduced resources to develop cost allocation rules,[16] are not compelling, when compared against the magnitude of the problems raised by combining video dialtone and narrowband costs and revenues. Ad Hoc and the majority of non-LEC parties identified these problems in their comments.[17]

In particular, Southwestern Bell's claim that "[t]here would be little, if any evidence on which to develop those [cost allocation] rules, and doing so would only delay the introduction of VDT services,"[18] defies the reality of the

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[14] *Id.* at 19-20.

[15] BellSouth Comments at 14.

[16] Southwestern Bell Comments at 8-9.

[17] NYNEX Comments at 10; US WEST Comments at 14; Comments of the United and Central Telephone Companies at 3; Comments of the National Cable Television Association, Inc., at 8; AT&T Comments at 5 ("AT&T Comments"); Comments of Cox Enterprises, Inc., at 25; Comments of the General Services Administration at 6-7; MCI Comments at 12-13.

[18] Southwestern Bell Comments at 9.

Commission's video dialtone process. First, the Commission has been gathering evidence upon which to base cost allocation rules throughout the Section 214 and tariff review processes that have been ongoing since the end of 1992. Second, it would appear that the LECs are slowing their efforts to introduce VDT services.[19] Under such circumstances, claims of potential short-term delay ring hollow, and are far outweighed by the significant long-term benefits of reducing the risk of massive cross-subsidization of video dialtone services.

Ad Hoc commends those LECs, such as US WEST and NYNEX, who support separating the costs and revenues of video dialtone services from other services in recognition of concerns regarding potential cross-subsidization and earnings manipulation.[20] However, Ad Hoc disagrees with US WEST[21] and NYNEX,[22] respectively, that the removal of VDT expenses and revenues from the calculation of a LEC's interstate rate of return will necessarily avoid all charges of earnings manipulation and cross-subsidization, and "break any link between VDT and charges for other interstate access services."

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[19] Ameritech and NYNEX have not yet filed proposed tariffs that would permit them to offer video dialtone services, despite the granting of their 214 applications on January 4 and March 6 of this year. Bell Atlantic recently submitted a letter to the Commission requesting the Commission suspend its impending approval of the majority of Bell Atlantic's video dialtone applications. Bell Atlantic *Ex Parte* Letter to Kathleen Wallman (April 25, 1995). Presumably, these actions and non-actions are based, at least in part, upon financial analyses that have been undertaken by the respective companies. That cost assignment studies have not been undertaken by the LECs' for purposes of forecasting return on their video investments stretches credulity past reasonable limits.

[20] NYNEX Comments at 10; US WEST Comments at 14. Ad Hoc notes that these happen to be the two RBHCs that have elected to remain under a sharing obligation by opting to operate under a 4.0% X-Factor.

[21] US WEST Comments at 15.

[22] NYNEX Comments at 10.

As cautioned above in the context of establishing a separate basket for video dialtone services, the removal of video dialtone expenses and revenues from the calculation of carriers' interstate earnings is not in and of itself sufficient to ensure that video dialtone costs are not recovered through charges for other interstate access services. To achieve this important objective, the Commission must not only institute a number of changes regarding the application of price caps to video dialtone,[23] it must also remain committed to a diligent and thorough tariff review process that results in the economically correct assignment of the underlying broadband network costs to the video service category.

CONCLUSION

Ad Hoc's Initial Comments support the Commission's prior decision to include video dialtone services in the price cap regulation scheme and the Commission's tentative conclusion that video dialtone services should be segregated into a separate price cap basket. LEC arguments to the contrary are unpersuasive. The LECs do not recognize the bottleneck character of their video dialtone services, nor do they accept the implications of the highly integrated infrastructure out of which both conventional and video services are to be furnished.

Establishing a separate price cap basket for video dialtone, setting the X-Factor for that basket at 0, and increasing the X-Factor for the remaining (non-video) baskets are necessary to assure that the LECs' video dialtone initiatives are not cross-subsidized by their existing monopoly services ratepayers.

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[23] These changes include the creation of a separate basket for VDT services and the unbundling of the productivity factor as between VDT services and other LEC interstate services.

Accordingly, Ad Hoc urges the Commission to adopt the proposed recommendations that have been advanced in these Reply Comments and in the Initial Comments.

Respectfully submitted,

AD HOC TELECOMMUNICATIONS
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