

Before The
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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MAY 11 1994
COMMUNICATIONS SECTION

In the Matter of
Price Cap Performance Review
for Local Exchange Carriers
Treatment of Video Dialtone Services
Under Price Cap Regulation

CC Docket 94-1

REPLY COMMENTS OF BELL ATLANTIC¹

The initial comments make clear that this proceeding is an opportunity for the Commission to further implement its policy that regulation should yield to the forces of market competition. As explained in the accompanying affidavit of Dr. Robert W. Crandall, there is simply no valid argument to suggest that local exchange carriers (LECs), which will enter the video distribution business with a zero market share in competition with entrenched incumbents, have sufficient market power to require price regulation of video dialtone. Indeed, the considerations recently applied by the Commission in removing AT&T's commercial

¹ The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; Bell Atlantic-West Virginia, Inc.

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services from price caps apply even more strongly to video dialtone service.²

If the Commission nonetheless stretches its price cap regulation to include video dialtone services (which it should not), it should limit that regulation to the minimum intrusion on the competitive market. This means regulatory parity with video dialtone's cable competitors and no additional regulations such as earnings sharing or creation of service category pricing bands for sub-groups of video dialtone services.

I. Video Dialtone is a Competitive Service that Should Not be Regulated Under Price Caps.

A majority of the commenters recognize that as the newest entrants in the video distribution market, LECs should not be the only market participant subject to price regulation.³ As most commenters understood, exchange carriers "will enter the video transport and programming businesses with virtually no market share and no market power at all."⁴ Also, as Dr. Robert Crandall

² Compare Revisions to Price Cap Rules for AT&T Corp., Docket No. 93-197, Report and Order at ¶¶ 16, 17, 20, 22 (rel. Jan. 12, 1995) with attached Affidavit of Robert W. Crandall ("Crandall Affidavit"). Video dialtone has no market share. The recent success of new entrants to the video services market such as Direct Broadcast Satellite ("DBS") show a high degree of demand responsiveness. As digital technology expands the capacity of video dialtone competitors, supply responsiveness is also increasing dramatically.

³ See, e.g., Bell Atlantic Comments at 2-5; Pacific Bell Comments at 2-5;; United States Telephone Association Comments at 1-3; U S West Comments at 3-12; and Rochester Telephone Comments at 2-6.

⁴ Rochester Telephone Comments at 3.

explains, video dialtone is neither a bottleneck for video customers or for video programmers.⁵ Only one commenter argues that the video services market is not sufficiently competitive, and its arguments do not withstand scrutiny.⁶

Specifically, MCI argues that "over time LECs could succeed in driving out cash-strapped cable firms from the wireline video delivery business."⁷ But Dr. Crandall explains that, with plant already in place and low marginal costs, cable companies are well positioned for vigorous price competition.⁸ Under these circumstances, telephone companies could not possibly hope to drive cable companies out of business and would be foolhardy to try.⁹ As a result, claims that telephone companies would engage in predatory pricing are not credible.

MCI also suggests that price caps on *video dialtone* service are required because of LEC market share for *traditional telephony services*.¹⁰ Again, MCI is wrong. As Dr. Crandall¹¹

⁵ Crandall Affidavit at ¶ 16.

⁶ MCI Comments at 3.

⁷ *Id.* at 4.

⁸ Crandall Affidavit at ¶ 19. *See also* Speech of Chairman Reed E. Hundt at the National Cable Television Association at 5 (May 9, 1995) ("No industry has a better chance than cable to be the leader in the country's conversion to the digital age").

⁹ Crandall Affidavit at ¶ 19; *Matsushita Elec. Ind. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 584-85 (1986).

¹⁰ MCI Comments at 3.

¹¹ Crandall Affidavit at ¶¶ 18-19.

and other commenters make clear,¹² both the robust competition that LECs will face in the video services market and the price regulation of LEC telephony services eliminate the possibility of cross-subsidization. Moreover, for those companies that are no longer subject to sharing requirements, cross subsidization is both impossible and pointless.

II. If the Commission Does Regulate Video Dialtone Services Under Price Caps, It Should Limit Such Regulation so as to Avoid Additional Intrusion on the Competitive Market.

If the Commission were to nevertheless require price cap regulation of video dialtone (which it should not), most commenters are in agreement that video dialtone should not be subject to a productivity offset.¹³ One commenter favoring a zero productivity offset, however, suggests that the productivity

¹² See, e.g., Rochester Telephone Comments at 4 (LECs interstate telephone services will remain subject to price cap regulation and "therefore, cannot be used to subsidize video dialtone offerings"); US West Comments at 2 (the Commission must base its regulation on a company's market power in the market to be regulated and not some other market).

¹³ See, e.g., Bell Atlantic Comments at 6; NYNEX Comments at 6-8; United and Central Telephone Companies Comments at 3; Cox Enterprises Comments at 21-25. MCI argues that because of a "lack of historical perspective and data" it is impossible to estimate the likely productivity gains for video dialtone and the Commission should use the existing LEC offset. MCI Comments at 10. MCI acknowledges, however, that video dialtone services have "different market characteristics than telephony services." *Id.* at 6. When faced with similar uncertainty for cable companies, the Commission found that no productivity offset was appropriate. See Bell Atlantic Comments at 6 and cases cited therein. No commenter has offered a reason for disparate treatment of video dialtone providers, which will use many of the same technologies as cable companies to compete with cable for the same pool of ultimate customers.

offset on other LEC services be increased to compensate for the exclusion of video dialtone services.¹⁴ This ignores the Commission's recent revaluation of LEC productivity. While the Commission committed a number of errors in that revaluation that are currently the subject of appeal,¹⁵ there is no factual basis to suggest that average productivity growth would have been higher still but for the as yet unbuilt video dialtone networks of the LECs.

Commenters also recognize that "the Commission lacks any information regarding the technical parameters and relative competitive pressures that bear on LEC video offerings sufficient to identify meaningful subclasses that should be placed in separate service category bands within a video basket."¹⁶ Moreover, separate service category bands, which put additional limitations on the ability to adjust prices, make no sense for a service whose prices are already constrained by market competition. Commenters also recognize that, should the Commission put video dialtone in a price cap basket, it is

¹⁴ Ad Hoc Comments at 12-13.

¹⁵ Joint Petition for a Partial Stay and for Imposition of an Escrow or Accounting Mechanism Pending Judicial Review, CC 94-1 and CC 93-179 (filed May 9, 1995).

¹⁶ Cox Enterprises Comments at 13.

premature to suggest additional broadband transport services that should be included in that basket.¹⁷

While commenters generally support setting any video dialtone price cap index based on the existing new services rules,¹⁸ one commenter -- a cable company -- argues that Part 64 fully distributed costs should be used instead.¹⁹ There is simply no basis for, and no regulatory mechanism to, single out one new service for a wholly separate costing methodology. Moreover, requiring a price floor of fully distributed costs would ensure that LEC video dialtone services could not compete with incumbent cable service providers, which are able to price their services at incremental cost. The result of using an artificially high measure such as fully distributed cost would be to allow cable to escape all rate or price regulation and to establish a "price umbrella" under which it could set its prices at super-competitive levels. This may benefit cable companies, but would harm consumers.

Commenters also recognized that video dialtone services should be excluded from sharing requirements for those companies

¹⁷ See, e.g., NYNEX Comments at 5 (some services using broadband architecture are already regulated under existing price cap rules; other future services are not yet known in terms of type, structure and packaging).

¹⁸ See, e.g., GTE's Comments at 17-18; MCI Comments at 11.

¹⁹ Cox Enterprises Comments at 16.

still subject to earnings sharing.²⁰ Moreover, it was also recognized that "continuation of Part 69 waiver proceedings will only duplicate existing tariff procedures that permit a through evaluation of proposed [video dialtone] rate structures and cost assignments."²¹ These redundant regulatory proceedings should be eliminated in order to further regulatory parity and promote the development of additional competition.

III. The Commission Should Ignore Irrelevant Comments.

Several commenters raise issues unrelated to price cap treatment of video dialtone, and instead seek to reargue other Commission decisions. For example, some commenters argue the Commission should rethink its decision not to rewrite its

²⁰ See, e.g., US West Comments at 14-15; Comments of the National Cable Television Association, Inc. ("NCTA Comments") at 8. If the Commission nevertheless imposes a sharing requirement on video dialtone services, the earnings for video dialtone should be included as part of the overall sharing calculation for interstate services. Absent a recognition of the level of competition and the need for regulatory parity, video dialtone must be treated like any other service regulated under price caps and no separate rules are appropriate.

²¹ GTE's Comments at 16. See also Rochester Comments at 6-7.

separations and other cost allocations rules exclusively for video dialtone.²² This Commission understood that the "existing rules adequately protect consumers against improper cross-subsidy and anti-competitive activity."²³ This is even more true today, with a number of LECs now regulated under a price cap regime without sharing, and without the perversion of incentives associated with rate of return regulation.

²² See Ad Hoc Comments at 6; NCTA Comments at 2-6; and MCI Comments at 14-15. NCTA and Ad Hoc specifically complain that the costs common to voice and video identified in Bell Atlantic's proposed video dialtone service tariff for Dover Township, New Jersey should *all* be assigned to video dialtone. This argument, raised in the wrong forum, is inconsistent with Commission rules and economic logic. *Telephone Company-Cable Television Cross-Ownership Rules*, 10 FCC Rcd 244, 332-34 (1994) ("VDT Reconsideration Order"); see also Affidavit of William E. Taylor at ¶¶ 16-20, Exhibit 1 to Opposition of Bell Atlantic to Petition to Deny, W-P-C 6912 and W-P-C 6966 (filed Aug. 6, 1994). Ad Hoc goes even further, using the costs for the technology deployed in Dover (including all common costs) as a local proxy for the costs for national deployment of video dialtone using a variety of technologies. Ad Hoc Comments at 15. Ad Hoc argues that this convoluted calculation of video dialtone costs exceeds the book value of all companies making video dialtone investments. This extrapolation is not valid. Moreover, while it is true that broad scale deployment of video dialtone capabilities will require significant capital investments, this fact merely emphasizes the need to eliminate unnecessary regulatory constraints that undermine investment incentives.

²³ VDT Reconsideration Order at ¶ 169.

Conclusion

The Commission should promote equitable competition by removing video dialtone from price cap regulation.

Respectfully submitted,

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Dated: May 17, 1995

Affidavit of Robert W. Crandall

1. My name is Robert W. Crandall. I am a Senior Fellow in Economic Studies at the Brookings Institution in Washington, DC.¹ I am the author of numerous books and journal articles on regulation, including After the Breakup: U.S. Telecommunications in a More Competitive Era (1991) and Talk is Cheap: The Promise of Regulatory Reform in North American Telecommunications (forthcoming, 1995).

2. I have taught industrial organization and regulation at M.I.T., George Washington University, and the University of Maryland. In addition, I have served as an advisor to a Commissioner of the FCC, a consultant to the Commission in its revision of the cable-television signal-carriage rules in 1979, as a consultant to the Bureau of Competition in Canada in its recent participation in telecommunications-regulation proceedings before the CRTC, and as a consultant to various other government agencies on regulatory and antitrust matters.

3. I have been asked by Bell Atlantic to offer my views on the application of price caps to

¹ The views expressed in this affidavit are my own and are not necessarily those of the Brookings Institution, its other staff members, or its Trustees.

prospective video dial-tone services to be offered by Bell Atlantic and other telephone companies. In addition, I have been asked to respond to comments offered by other participants in this proceeding.

Price Caps

4. Price caps have been implemented by the Commission as a substitute for cost-of-service regulation for telecommunications carriers in an environment of rapid technical change and competitive entry. This substitution has occurred to provide greater incentives for carrier efficiency and innovation as well as to eliminate incentives for cross-subsidizing more competitive services from regulated monopoly services. However, the Commission has recognized that such price caps should be utilized only for the regulated monopoly services, not for competitive services. Since carriers cannot exert power over rates for competitive services, there is no need for strict regulation of them. For this reason, the Commission has eliminated price-cap regulation for virtually all of AT&T's Basket 2 and 3 services (primarily business services), substituting a "streamlined" reporting and approval process for these services.²

5. Despite their superiority over traditional cost-based regulation, even price caps have some adverse effects on regulated carriers' incentives. For instance, the Commission's LEC price

² FCC, *Competition in the Interstate Interexchange Marketplace*, Second Report and Order, May 14, 1993.

caps historically have included an earnings band, requiring some carriers to "share" earnings with ratepayers if these earnings exceed a specified percentage of invested capital through subsequent rate reductions. The effects of such a formula on carrier incentives to reduce costs or increase consumer demand are obvious.³ If, for example, carriers succeed in achieving substantial cost reductions while keeping rates within the limits of the price caps, they may be penalized for such success if they are later forced to share such successes with ratepayers under the profit-sharing formula. Such regulatory recapture of the hard-earned fruits of management's efforts will surely reduce the incentives to seek such efficiency improvements. In addition, the Commission must periodically review the price-cap formula, and it may adjust the formula if it thinks that it has underestimated the productivity (X) factor and allowed carriers to earn excessive profits. Indeed, the Commission has just completed such an exercise for the LEC price cap, requiring a substantial downward adjustment in carrier access rates.⁴ Such adjustments are likely to reduce carrier incentives to improve efficiency because they recognize that they are likely to have to return some of the profits from sharp increases in such efficiency in later years.

Video Dial-Tone

³ The Commission has recognized this infirmity in its LEC price caps, but it has retained sharing under some of the options established in its recent LEC price-cap ruling. See First Report and Order (1995) as cited in fn. 2 above.

⁴ FCC, In the Matter of Price Cap Performance Review for Local Exchange Carriers, First Report and Order, March 30, 1995.

6. Video dial-tone is a common-carrier service that has been approved by the Commission as a means by which regulated telephone companies could offer a video transport service to multiple video programming providers. This service is very much in its early stages as telephone companies test a number of new technologies, such as ADSL, fiber to the curb, and hybrid fiber/coaxial cable (fiber to the pedestal), and a variety of one-way and interactive services. It is important to understand that commercial video dial-tone service does not yet exist on a widespread basis in any region of the country.

7. As originally conceived, video dial-tone service would simply be a communications transport service offered by regulated telephone companies to third-party video programmers. However, recent court decisions have overturned the telephone company/cable ban and enjoined its enforcement against any telephone company. Prospective legislation may eliminate the statutory ban altogether. As a result, Bell Atlantic and other telephone companies are now actively pursuing video program development with the intention of offering such programming over their own networks.

Competition in Video Program Distribution

8. It must be stressed that video dial-tone service is being launched into a market with substantial existing competition. In the past twenty years, video program distribution has undergone revolutionary changes. In 1975, only 15 percent of all households subscribed to cable

television and even these households generally received no more than 12 channels of service. Video cassette players were still in the development stage. There were only three commercial broadcast television networks. Satellites were only beginning to develop as carriers of video programming to cable systems and broadcast stations; consumers did not receive programming directly from satellites. Today, video dial-tone will be entering the marketplace in competition with a number of video distribution services.

9. The principal competitor is the well-established cable television industry. By the end of 1994, more than 60 percent of all households subscribed to basic cable television service, and more than three-fourths of these households received at least 30 channels of service.⁵ Nearly 90 percent owned video cassette players, and these households' video rentals and purchases accounted for about half of all revenues for U.S. motion picture companies.⁶

10. A second source of competition is the existing array of wireless satellite distribution services. Approximately 4 million households now own large-diameter (2-3 meters) satellite receive-only dishes capable of receiving scores of programming services.⁷ More importantly, in

⁵ FCC, In the Matter of Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, First Report, September 19, 1994.

⁶ Paul Kagan Associates, February 28, 1994. According to the Department of Commerce, video cassette rentals and sales now account for between \$12 billion and \$17 billion in annual sales revenues. U.S. Department of Commerce, U.S. Industrial Outlook 1994, pp. 31-34.

⁷ FCC, In the Matter of Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, CS Docket 94-48, First Report, September 19, 1994, p. 36. (Hereafter, First Report).

1994, Hughes Aircraft launched a pair of high-powered direct-broadcast satellites (DBS) over which two programming-service providers, one affiliated with Hughes (DirecTV) and the other with Hubbard Broadcasting (USSB), now offer about 175 channels of programming in direct competition with cable television services. DirecTV/USSB now have more than 500,000 subscribers and expect to have 2 million subscribers by the end of 1995.⁸ A third direct-broadcast service, PrimeStar, has another 300,000 subscribers to its medium-power 70-channel service, but it is now proceeding to obtain the authority to launch its own high-powered satellites, capable of offering 200 channels of service.⁹ A fourth DBS service, EchoStar, is now seeking Commission approval to launch its own high-powered satellites.

11. In addition to these two principal wireline and wireless competitors, there are a number of other video distribution services that are available to programmers. Some of these services may be used by telephone companies or their programming operations as alternative distribution technologies to supplement their wireline video-dialtone networks. These include Satellite Master Antenna Television (SMATV) systems and by wireless terrestrial systems. SMATV systems are essentially cable systems that are confined to a single apartment building or complex, receiving signals through satellite dishes and distributing them throughout the building or complex via coaxial cable. These systems now number 3000 to 4000 and have more than 1 million

⁸ "Digital TV: Advantage Hughes," Business Week, March 13, 1995, pp. 66-68.

⁹ Id.

subscribers.¹⁰ In addition, multichannel multipoint distribution services (MMDS) now offer 30 channels of video service to more than 500,000 subscribers.¹¹ With digital signal compression technologies and additional spectrum, made possible by the Commission's liberalization of spectrum-allocation policies, these systems could proliferate and expand their video offerings substantially. Finally, a new "cellular" wireless cable service, using low-powered transmission from numerous cells within a given market, is in operation in the 28 GHz band in New York City (and Calgary, ALB, Canada). While its potential is still essentially untested, this new technology provides evidence of the many ways in which video programming may be delivered to households over wireless networks.

12. Finally, there are the terrestrial broadcast stations. Although these stations are currently limited to one channel and there are few of them in each market, if, as the result of the HDTV proceedings and the installation of digital technology, they become multichannel distribution media, they too are likely to be significant competitors in the future. However, these stations are surely competitors of cable, DBS, and of the new VDT systems in the present marketplace, attracting a substantial share of the video audience.

13. It will require at least two or three years to build telephone-company video dial-tone

¹⁰ First Report, pp. 44-5.

¹¹ First Report, p. 38.

platforms and distribution networks. By this time, the video distribution market is likely to be even more intensely competitive. At least three competing DBS services are likely to be in operation by this time, each offering several hundred channels of service. Cable television will be forced to invest in digital technology so that it may also offer several hundred channels of basic, premium, pay-per-view, and interactive services. And for motion pictures, virtually every household will continue to have the option of renting or purchasing a video cassette from local retail outlets, although the direct-to-home distribution channels may be so competitive as to make the transactions costs of the retail purchase/rental alternative to consumers essentially prohibitive.

14. In this environment, telephone companies will have to offer innovative new services to compete successfully with the cable, satellite, and other providers who will obviously have substantial first-mover advantages in offering traditional "cable television" services. If they are to be successful, telephone companies will obviously not be offering simply a standardized video package, nor will they be simply leasing standard one-way (distributive) video channels to traditional video program services, such as The Learning Channel or HBO.

Regulating Video Dial-Tone Services

15. Given the dramatic increase in viewing options available to most households, it is difficult to predict the types of services that may be offered over telephone-company video networks. These services will undoubtedly be a mixture of one-way and interactive services

offered in different proportions over network configurations that differ across telephone companies. In short, video dial-tone will not be a standardized, homogeneous utility service. Nor could one define it as an essential consumer service, such as local telephone access, electricity service, or water. Moreover, given the rapid evolution of video-distribution technologies, it would be difficult to measure the cost of one "average" or "representative" channel of service and the recent or prospective change in productivity implicit in such distribution networks -- calculations required to launch a rate-cap regime.

16. Video dial-tone service is not likely to be one in which the telephone-company provider enjoys any systematic market power. With a multitude of satellite-based and cable-television suppliers, each offering more than 100 channels of service, video dial-tone services will undoubtedly face strong competition. As the Commission has recognized, there is no need for strict regulation of rates for those services in which the carrier is nondominant. In CC Docket 87-266, the Commission addressed this issue and concluded that "...carriers offering video dial-tone service maintain control over an essential bottleneck facility, *i.e.*, the basic platform..."¹² But the VDT "bottleneck" is only essential to using **this carrier's** video network. It is clearly not a bottleneck for video programmers who may choose to distribute their products over cable television systems, satellite feeds to home satellite dishes, one of several national DBS systems, or

¹² FCC, *In the Matter of Telephone Company-Cable Television Cross Ownership Rules 63.54-63.58 and Amendments of Parts 32, 36, 61,64, and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking*, October 20, 1994, p. 96.

even through the distribution of video cassettes. To refer to a telephone company's (as yet unbuilt) video platform as an "essential facility" is similar to arguing that each of scores of national trucking companies should be regulated because each one's terminals are bottleneck facilities that are essential to its own operations. But every shipper has the choice of scores of different trucking companies and therefore of scores of sets of "bottleneck" facilities. The fact that VDT is a common-carrier service while other competitors' services are not is not relevant to the issue of whether VDT faces significant competition. Video providers have multiple outlets for their services regardless of whether these other video distribution services are organized or regulated as common carriers.

17. Nor is video dialtone rate regulation necessary to prevent cross-subsidization by telephone companies. As long as their "monopoly" services are controlled by price caps, there is simply no need to regulate their competitive service rates. The Commission has recognized this fact in successively eliminating a variety of services from the AT&T rate caps. State regulators have often followed a similar regulatory strategy with regard to a variety of non-core, central-office services, such as voice mail and call forwarding, in which carriers are nondominant.

18. In its comments in this proceeding, MCI argues that the Commission should place VDT services in a separate basket in the interstate LEC price caps to prevent cross-subsidization

from "monopoly" services to the VDT services.¹³ In making this request, MCI grants that VDT services are not monopoly services and that the Commission need not worry that monopoly rents from VDT services will be used to cross-subsidize other **unregulated** competitive services. Rather, MCI wants VDT services in the price caps to keep the LECs from reducing VDT service rates and assigning the costs of these VDT services to "monopoly" interstate access services. MCI appears to misunderstand the role of price caps, which are applied only to services over which the regulated firm purportedly has **monopoly power** to prevent the firm from **raising** those prices to cross-subsidize competitive ventures. The LECs cannot shift the costs of competitive services, such as VDT, to "monopoly" services precisely because the latter are subject to price caps. Placing VDT in the price caps would make no more sense than placing other services that the Commission has been found to be competitive, such as those offered by AT&T that have been dropped from Baskets #2 and #3, in the price caps. Price caps are designed as control mechanisms for monopoly services, not competitive services that require no regulation.

19. Even if the Commission were worried that the absence of price caps for VDT might somehow encourage the LECs to engage in predation, it should ask whether the LECs would be so foolish as to launch a predatory price war against established cable companies whose costs are almost entirely sunk. Given the very considerable capital resources of the country's major cable MSOs, such as TCI and Time-Warner, such a predatory war would be long and costly to the

¹³ MCI Comments, April 17, 1995.

predator. Moreover, even a victory would be no more than pyrrhic because another entity would be able to purchase the sunk assets of the cable company in the most unlikely event that it was driven into bankruptcy by the price war. Moreover, DBS service providers backed by large firms, such as General Motors, have also made large fixed investments and are similarly unlikely to be driven out of business by new video dial-tone providers. One can hardly imagine a business in which the incumbent firms are better prepared to discourage predation than the current video distribution business.

20. Price-cap regulation of video dialtone service is not only unnecessary; it is likely to be counterproductive because it will reduce the incentive for telephone companies to innovate. First, because of the rapid evolution of new technologies and services, any attempt to define the service and set reasonable initial rates is likely to be successful, if at all, for only a short period of time. If each carrier must submit to a formal process of revising its rates for video carriage each time it alters its service, it will be much less inclined to experiment with new service offerings. Because video dialtone service is still largely untried, the likelihood of such changes in service design is very high. It would be unfortunate and anticompetitive if video dialtone providers had to pursue a contentious regulatory process to make changes in their service offerings while other distribution services, such as cable or DBS could adapt quickly to new market demands or technologies.

21. Another source of potential disincentives to innovate derives from the need for the Commission to adjust price caps in response to changes in market conditions. If, for example,

video dialtone service proves to be much more profitable than the Commission or the telephone companies had anticipated, perhaps because the decline in costs is much more rapid than initially forecast, the Commission will be under pressure to re-examine the basis for setting the productivity offset in the video dialtone price cap (the "X factor"). As mentioned above, regulated telephone companies have recently experienced precisely this phenomenon in the recent LEC price cap revisions.¹⁴ Although rate caps are more incentive-compatible than traditional cost-based regulatory mechanisms, this possibility for subsequent and even retroactive revision in the rate-cap formula surely will reduce the rate of investment in innovative new video distribution technologies.

Conclusion

22. The telephone companies are now exploring their options for entering a rapidly-changing and increasingly-competitive video distribution market. They are likely to have to commit billions of dollars to video platforms, most of which will be in the form of irretrievably sunk costs, and to confront numerous competitors who have a substantial first-mover advantage. In this environment, imposing rate caps on telephone-company video dialtone services is not only unnecessary, but counterproductive. No form of regulation is conducive to innovation; rate caps are simply less punishing than cost-based forms of regulation. The Commission should

¹⁴ See fn. 4 above.

ignore the pleadings of other competitors in the video-distribution market and limit rate caps to those services over which the carriers may reasonably be determined to have market dominance.

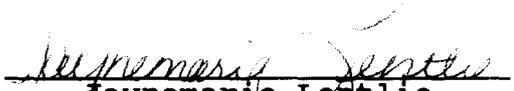


Robert W. Crandall

Dated: May 17, 1995

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing "Reply Comments of Bell Atlantic" was served this 17th day of May, 1995 by first class mail, postage prepaid, on the parties on the attached list.


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