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

In the Matter of	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
Treatment of Operator Services Under Price Cap Regulation	)	CC Docket No. 93-124
Revisions to Price Cap Rules for AT&T	)	CC Docket No. 93-197

SECOND FURTHER NOTICE OF PROPOSED RULEMAKING IN CC DOCKET NO. 94-1, FURTHER NOTICE OF PROPOSED RULEMAKING IN CC DOCKET NO. 93-124, AND SECOND FURTHER NOTICE OF PROPOSED RULEMAKING IN CC DOCKET NO. 93-197

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By the Commission: Commissioner Barrett issuing a statement.

TABLE OF CONTENTS

Topic		Paragraph No.
I.	Introduction	1
II.	Background	9
III.	Goals and Regulatory Principles	18
IV.	Revisions to the LEC Price Cap Plan	32
	A. General	32

B. Proposed Modifications to the Price Cap Plan 37

1. Introduction..... 37
2. Implementation of Service Offerings and Rate Changes 38
   a. Introduction 38
   b. New Services and Restructures 39
   c. Alternative Pricing Plans 54
   d. Individual Case Basis Tariffs 61
3. Part 69 Waiver Process 66
4. Elimination of Lower Service Band Index Limits and Other Pricing Flexibilities 75
5. Revision of Baskets 86
6. Consolidation of Service Categories 93
7. Further Notice of Proposed Rulemaking in CC Docket No. 93-124 96
   a. Operator Services 96
   b. Call Completion Services 99
8. General Issues 103

C. Measures of Competition for Regulatory Relief 106

1. Introduction 106
2. Removal of Barriers to Local Competition 107
3. Procedural Matters 111

D. Relevant Markets 116

1. Introduction 116
2. Relevant Product Market 117
3. Relevant Geographic Market 120

V. Streamlined Regulation 127

A. Background 127

1. General 127
2. Criteria Used for AT&T in CC Docket Nos. 90-132 and 93-197 130

B. Proposed Factors for Determining When Streamlined Regulation is Warranted 133

1. Demand Responsiveness 134
2. Supply Responsiveness 138

3. Market Share 142
4. Pricing of Services Under Price Cap Regulation 144
5. Other Factors 146

C. Contract Carriage 147

D. Procedural Matters 151

VI. Nondominant Treatment 152

VII. Other Issues 159

A. Other Changes to the LEC Price Cap Plan 159
1. X-Factor Flexibility 159
2. Relaxation of Sharing Requirements 163

B. Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197: Changes to AT&T's Price Cap Plan 173

VIII. Procedural Matters 175

A. Regulatory Flexibility Act 179

B. *Ex Parte* Rules - Non-Restricted Proceeding 180

C. Comment Filing Dates 181

IX. Ordering Clause 182

I. INTRODUCTION

1. The purpose of this Second Further Notice of Proposed Rulemaking (Second Further Notice) in CC Docket No. 94-1 in our performance review of the LEC price cap plan is to consider and propose specific changes to interstate access price regulation to respond to changes in the market for these services and to rely more heavily on market forces to achieve our public policy goals. The changes we contemplate are specifically designed to benefit consumers by: (1) encouraging market-based prices that reflect the cost of service; (2) encouraging efficient investment and innovation; (3) encouraging competitive entry in the interstate access and related local exchange markets; and (4) permitting us to regulate noncompetitive markets in the most efficient and least intrusive way.

2. We propose here to establish a framework for three gradations of increasingly less stringent price regulation. At the first level, we seek comment on, and in certain cases propose, a number of modifications within the price cap plan. Specifically, we consider (1) clarifying and simplifying the treatment of new and innovative tariff offerings for price cap LECs; and (2) making certain modifications relating to the price cap plan itself, including allowing certain downward pricing flexibility and changing the structure of the service baskets and categories within the plan.[1] We believe the changes we propose will facilitate the introduction of services and the alignment of rates with costs without posing any threat to competition or consumers. We propose that generally these rule revisions be effective for all price cap LECs without regard to the current level of competition because they will serve our goals of moving prices toward costs, encouraging efficient investment in infrastructure, and ultimately producing robust competition. An alternative approach would be to require LECs to satisfy an objective set of criteria established by the Commission indicating the presence of a certain measure of competition for a particular service or services within a prescribed geographic market before certain of the proposals would be effective. Even where we decide not to adopt a particular change to the price cap rules at this time, we believe that establishing the criteria under which such a rule change would be implemented may facilitate the removal of barriers to entry in exchange and access markets, and discourage inefficient investment in infrastructure by potential entrants.

3. At the second level, for price cap LECs that are able to demonstrate substantial competition for particular services within a geographic market, we propose to remove those services from price cap regulation in that market and place them under streamlined regulation. Streamlined regulation would permit price cap LECs to file tariffs on 14 days' notice; the tariffs would be presumed lawful for purposes of review, would be filed without cost support, and would no longer be subject to price cap ceilings, or upper or lower pricing

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[1] For example, in Section IV.B.7., we consolidate CC Docket No. 93-124 with our performance review of the LEC price cap plan so that we can consider in the context of larger changes to the price cap plan the question of whether a separate basket should be created for operator services or whether it should be combined into one basket with another service or services.

limits. At the third level, we propose that a price cap LEC that demonstrates that it no longer exercises market power for particular services in a geographic market would qualify for nondominant regulation as to those services in that market. Under non-dominant regulation, price cap LECs would file tariffs on one day's notice with no cost support.

4. We also discuss certain other miscellaneous issues relating to competition, such as whether competitive considerations should influence the X-Factor used by or sharing obligations imposed on price cap LECs, and whether to treat changes in competitive access providers' (CAPs) rates exogenously in AT&T's price cap plan.

5. Although we recently found in the *First Report and Order* in CC Docket No. 94-1 that LECs retain considerable market power, we also took notice of the growing evidence that an increasing variety of local telecommunication services are available on a competitive basis.[2] We are issuing this Second Further Notice in response to these signs of changing market structure, and we propose to revise our regulations to protect and foster competition and allow market forces to operate where they are present. Competition is the surest means of achieving the consumer benefits we seek to promote.

6. Even where competition has not yet arrived, we believe that certain changes to our price regulations will yield public benefits. For example, there may be situations in which regulation forces LECs with substantial market power to price above economic costs. Allowing greater downward pricing flexibility will benefit consumers both directly through lower prices and indirectly by encouraging only efficient competitive entry.

7. Our proposed regulatory changes are also intended to encourage the development of competitive conditions in both the interstate access and the related local exchange markets. We are of the view that interstate switched access competition cannot reach meaningful levels so long as end-users are exclusively reliant upon the incumbent LEC's switch to direct calls to interexchange carriers (IXCs).[3] This situation will be mitigated as barriers to local competition are eliminated. Consequently, we may want to condition certain relaxed regulatory treatment on reductions in entry barriers or demonstrations of actual competition for interstate access services. Properly designed, our system of price regulation should

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[2] Price Cap Performance Review for Local Exchange Carriers, First Report and Order, 10 FCC Rcd 8962, para. 25 (1995) (*First Report and Order*) (noting that this trend appears to be most pronounced in larger urban areas where new entrants appear to be marketing their services to high-volume toll users that offer the most lucrative returns).

[3] The Commission has previously acknowledged the relationship between interstate access and local exchange competition. *See, e.g.*, Transition Plan to Preserve Universal Service in a Competitive Environment, 10 FCC Rcd 7445, para. 39 (1995) (*NYNEX Universal Service Waiver Order*), *petitions for recon. pending*.

facilitate the transition to competition in local and interstate telecommunications markets by offering incentives for incumbents to foster competitive markets for particular services.[4]

8. In commenting on the specific proposals and issues set out below, we expect participants to address particularly, in addition to other issues, whether and how the proposed changes will affect innovation, efficiency, and elimination of implicit and explicit barriers to interstate access and local exchange competition. We also seek comments on whether there are any rules that should be eliminated or modified without regard to the level of competition because to do so would not harm competition or consumers and would serve our general policies of encouraging efficient pricing of access services and eliminating unnecessary and inefficient regulation.

II. BACKGROUND

9. In 1990, we replaced rate-of-return regulation for the Bell Operating Companies (BOCs) and GTE Operating Companies with price cap regulation, effective January 1, 1991,[5] and made price cap regulation optional for other local exchange carriers (LECs).[6] The LEC price cap plan was designed to simulate some of the efficiency incentives found in competitive markets and to act as a transitional regulatory scheme until the advent of actual competition makes price cap regulation unnecessary. Price cap regulation encourages LECs to improve their efficiency by harnessing profit-making incentives to reduce costs, invest efficiently in new plant and facilities, and develop and deploy innovative service offerings.

10. Under the price cap plan, there is a price cap index (PCI) for each of several different "baskets" of LEC access services. The PCI indicates the maximum level that LECs

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[4] In the case of AT&T, for example, the emergence of competition for specific interstate long distance services led us to remove those services from price cap regulation and subject them to streamlined regulation. *See* Competition in the Interexchange Marketplace, Report and Order, 6 FCC Rcd 5880 (1991) (*Interexchange Order*), *recon.*, 6 FCC Rcd 7569 (1991), *further recon.*, 7 FCC Rcd 2677 (1992), Second Report and Order, 8 FCC Rcd 3668 (1993), *recon.*, 8 FCC Rcd 5046 (1993); Revisions to Price Cap Rules for AT&T Corp., 10 FCC Rcd 3009, 3011, 3014 (1995) *(Commercial Services Order)*.

[5] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990) (*LEC Price Cap Order*), *recon.*, 6 FCC Rcd 2637 (1991) (*LEC Price Cap Reconsideration Order*), *aff'd sub. nom.*, *National Rural Telecom Assoc. v. FCC*, 988 F.2d. 174 (D.C. Cir. 1993).

[6] *LEC Price Cap Order*, 5 FCC Rcd at 6818 (para. 260). Those LECs electing price caps include United and Central Telephone Companies, Rochester Telephone Corporation, The Lincoln Telephone and Telegraph Company, and Southern New England Telephone Company.

may charge for services covered by the index.[7] The PCI is adjusted each year based on a measure of inflation that embodies economy-wide productivity gains and price changes,[8] minus a factor which reflects the fact that changes in telephone companies' costs per unit of output have historically been below that of the economy as a whole (or "X-Factor"). The PCI is further adjusted for certain exogenous cost changes.

11. LECs calculate a separate PCI for each of four price cap baskets. Each basket is designed to include similar services that have been grouped together to limit a LEC's ability to cross-subsidize different services.[9] The four baskets are: (1) common line, (2) traffic sensitive, (3) trunking, and (4) interexchange services.[10] In addition, the traffic sensitive and trunking baskets are subdivided into service categories, and we have established service band indexes (SBIs) and upper and lower pricing limits for each service category, which further limit the LEC's ability to price anti-competitively the services in those baskets. Rate changes that conform to the limits set by a LEC's PCIs and SBI bands are presumed lawful and permitted to take effect under limited review, on 14 days' notice. If a LEC files rates outside the PCI or service band pricing limits, we do not extend a presumption of lawfulness but rather require the filing of more extensive documentation and apply longer notice

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[7] The *LEC Price Cap Order* stated that it would allow above-cap tariff filings, but only in the unlikely event that the price cap rules have the effect of denying the LEC the opportunity to attract capital and continue to operate, despite the low-end adjustment mechanism and the opportunity afforded LECs to increase earnings through greater efficiency. *LEC Price Cap Order*, 5 FCC Rcd at 6823-24 (para. 304).

[8] In the *LEC Price Cap Order*, we used the Gross National Product Price Index (GNP-PI) as the inflation measure. *LEC Price Cap Order*, 5 FCC Rcd at 6792-93 (para. 50). In the *First Report and Order*, we replaced our inflation measure with the Gross Domestic Product Price Index (GDP-PI). *First Report and Order*, paras. 347-51.

[9] *LEC Price Cap Order*, 5 FCC Rcd at 6811; *see also* Policy and Rules Concerning Local Exchange Carrier Validation and Billing Information for Joint Use Calling Cards, CC Docket No. 91-115, 8 FCC Rcd 4478, 4483 (1993) (*BNA Order*), *modified on recon.*, 8 FCC Rcd 6393 (1993)(*First BNA Reconsideration Order*); *further modified on recon.*, 8 FCC Rcd 8798 (1993)(*Second BNA Reconsideration Order*).

[10] In the *Further Notice* in this docket, we solicited comment on whether to establish a separate price cap basket for video dialtone services, and whether to establish separate price cap rules governing that basket. Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation, CC Docket No. 94-1, 10 FCC 3141 (1995) (*Further Notice*). In a companion order we adopt today, we conclude that a separate basket for video dialtone services is necessary. Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation, Second Report and Order and Third Further Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 95-394 (adopted Sept. 14, 1995) (*Third Further Notice*).

periods. Above-cap and above-band filings carry a heavy burden of justification and a strong likelihood of suspension and investigation.[11]

12. The LEC price cap plan also includes sharing and low-end adjustment mechanisms, which are automatic adjustments to the PCI that are triggered by an individual LEC's rate-of-return performance. The sharing and low-end adjustment mechanisms were intended to compensate for the possibility of an error in the establishment of the X-Factor and variations among the different LECs.[12]

13. In the *LEC Price Cap Order*, we scheduled a performance review to evaluate the price cap system as implemented and LEC performance under that system.[13] We completed the first phase of this performance review in March 1995.[14] In Phase I of this proceeding, we adopted several interim revisions to the LEC price cap plan pending adoption of long-term revisions to the plan. First, we increased the X-Factor in the price cap formula. In the original plan, we had set the minimum X-Factor at 3.3 percent and had given the LECs the option of using a higher X-Factor of 4.3 percent. In the *First Report and Order,* we revised the minimum X-Factor to 4.0 percent and increased the number of X-Factor options from two to three, with the optional X-Factors set at 4.7 percent and 5.3 percent.[15] Second, we revised the rules governing sharing obligations and the low-end adjustments for the interim plan, including eliminating sharing and low-end adjustments for companies electing the 5.3 percent X-Factor.[16] Third, we revised our exogenous cost rules relating to changes in accounting rules.[17] We also adopted a number of other revisions to the LEC price cap plan, including changing the lower pricing limits that apply to most of the service categories within

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[11] *See* Section 61.49 of the Commission's Rules, 47 C.F.R. § 61.49; *see also* Transport Rate Structure and Pricing, 9 FCC Rcd 615, 627 n.3 (1994) (*Transport Second Report and Order*).

[12] *LEC Price Cap Order*, 5 FCC Rcd at 6801.

[13] *LEC Price Cap Order*, 5 FCC Rcd at 6834.

[14] *See First Report and Order*.

[15] *First Report and Order*, paras. 213-15.

[16] *First Report and Order*, paras. 220-22.

[17] *First Report and Order*, paras. 293-96.

the traffic sensitive and trunking baskets from 5 percent to 10 percent,[18] and changing the lower pricing limits that apply to density pricing zones from 10 percent to 15 percent.[19]

14. Although our initial price cap rules already gave the LECs greater pricing flexibility than rate-of-return regulation, during the first four years of LEC price cap regulation, the Commission took a number of significant steps to increase the LECs' pricing flexibility and ability to compete with new entrants. When we adopted the *LEC Price Cap Order*, the LECs were required to offer all special and switched access services at rates that are geographically averaged for each study area.[20] In the *Special Access Expanded Interconnection Order*, the Commission permitted LECs with operational special access expanded interconnection arrangements and at least one competitor in a study area to introduce zone density pricing for interstate high-capacity special access services (and other services found to be subject to competition) in that study area.[21] Zone density pricing is a system that permits the LECs gradually to reduce rates in geographic areas that are less costly to serve, and to increase rates, relatively speaking, in areas that are more costly to serve. Zone density pricing is implemented through special price cap service subcategories for each zone.[22] In the *Switched Transport Expanded Interconnection Order*, the Commission permitted LECs with operational switched transport expanded interconnection arrangements

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[18] *First Report and Order*, paras. 26, 408, 411; *id.* (determining that a 10 percent lower pricing band limit would provide the LECs with a reasonable additional amount of downward pricing flexibility, without risking predation or cross-subsidization).

[19] *First Report and Order*, paras. 408, 411.

[20] A study area is a geographical segment of a carrier's telephone operations. Generally, a study area corresponds to a carrier's entire service territory within a state.

[21] Expanded Interconnection with Local Telephone Company Facilities; Amendment of the Part 69 Allocation of General Support Facility Costs, 7 FCC Rcd 7369, 7454 n.411 (*Special Access Expanded Interconnection Order*), *vacated in part and remanded*, Bell Atlantic Tel. Cos. v. FCC, 24 F.3d. 1441 (D.C. Cir. 1994); Expanded Interconnection with Local Telephone Company Facilities, 9 FCC Rcd 5154, 5196 (1994) (*Virtual Collocation Order*).

[22] Transport Rate Structure and Pricing, 10 FCC Rcd 3030, 3042 (1994) *(Transport Rate Structure and Pricing)*. The zone subcategories have an upper pricing band of 5 percent and a lower band which we recently increased from 10 percent to 15 percent. *First Report and Order*, para. 411. In the year during which a LEC introduces zone density pricing, the LEC must apply the same upper and lower bands to all of the zone subcategories for a given service, but the rate levels may diverge to the extent permitted by the upper and lower bands without the justifications that the price cap rules require for above-band or below-band rates. *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7456, paras. 181-83; Expanded Interconnection with Local Telephone Company Facilities; Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board, 8 FCC Rcd 7374, 7430-32 (1993) *(Switched Transport Expanded Interconnection Order)*.

in a study area to implement zone density pricing for interstate switched transport in that study area.[23]

15. In the *Special Access Expanded Interconnection Order*, the Commission examined existing volume discounts and term discounts for special access services and found that they can be an effective approach to pricing that recognizes the efficiencies associated with larger traffic volumes and the certainty of longer-term arrangements.[24] In the *Switched Transport Expanded Interconnection Order*, and more recently in the *Virtual Collocation Order*, the Commission allowed the LECs to offer volume and term discounts for switched transport services after a certain degree of competitive entry has occurred in the relevant study area.[25]

16. We have demonstrated, in acting upon waiver petitions proposed by Rochester Telephone Corp. and the NYNEX Telephone Companies, our willingness to act on waiver petitions that seek relief from existing Part 61 and Part 69 rules in order to implement proposals for promoting and responding to competition in cases where special circumstances

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[23] *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7425-32, *aff'd, Virtual Collocation Order*, 9 FCC Rcd at 5196.

[24] *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7463. A volume discount would include, for example, lower per-unit rates for service with the capacity of multiple DS3s, while a term discount would include, for example, lower per-unit rates when a customer commits to continue using the service over a multi-year period.

[25] Specifically, we permitted LECs to implement volume and term discounts for switched transport rates in a study area when one of the following two conditions has been met: (1) 100 DS1-equivalent switched cross-connects are operational in the Zone 1 offices in the study area; or (2) an average of 25 DS1-equivalent switched cross-connects per Zone 1 office are operational. In study areas with no Zone 1 offices, volume and term discounts may be implemented once five DS1-equivalent switched cross-connects are operational in the study area. *Switched Transport Expanded Interconnection Order*, 8 FCC Rcd at 7435; *Virtual Collocation Order*, 9 FCC Rcd at 5202. A cross-connect is the cabling inside the LEC central office that connects the LEC network to the collocated equipment dedicated to a competitive access provider using expanded interconnection. *See* Section 69.121(a) of the Commission's Rules, 47 C.F.R. § 69.121(a). A Zone 1 office is a LEC end office located in the zone with the highest traffic density characteristics pursuant to the zone density pricing policies set forth in the expanded interconnection orders.

are shown to be present.[26] We have also promoted competition by permitting below-band rate changes, which cut transport prices by more than 70 percent, to take effect.[27]

17. In the initial *Notice* in CC Docket No. 94-1, we designated several issues as "Transition Issues."[28] We invited comment in the *Notice* on a variety of questions concerning the manner in which our current LEC price cap plan should be modified in order to adapt the system to the emergence of competition in local access and exchange telecommunications markets. In the *First Report and Order*, although we acknowledged the emergence of competition in a number of segments of the LECs' markets, we generally found that the record before us was insufficient on these issues, and we decided to defer them until this Second Further Notice.[29]

III. GOALS AND REGULATORY PRINCIPLES

18. A goal of our policies is to promote economic efficiency, which includes regulating prices so that they emulate the economic performance of competitive markets as closely as possible until actual competition arrives. This will ensure that the consumer welfare benefits approximate those of competitive markets, which should result in just and reasonable rates.[30] We also seek to encourage the transition to competition wherever it may be feasible. LEC price cap regulation is designed to promote economic efficiency by easing restrictions on overall profits while setting price ceilings at reasonable levels. Under price

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[26] *See* Rochester Telephone Corp. Petition for Waivers to Implement its Open Market Plan, 10 FCC Rcd 6776 (1995) (*Rochester Telephone Corp. Order*); *NYNEX Universal Service Waiver Order*, 10 FCC Rcd 7445, *petitions for recon. pending*. We also note a pending petition filed by Ameritech with the Commission regarding its plan to take certain measures that could facilitate competitive entry into the local exchange market concurrently with its proposed unbundling of access facilities. Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region (filed Mar. 1, 1995); Update to Ameritech Customers First Waiver Request (filed Apr. 12, 1995). The Department of Justice has reviewed Ameritech's plan and has filed a motion, which the Commission has supported, with the United States District Court for the District of Columbia to permit Ameritech to provide interexchange service under certain conditions.

[27] GTE Telephone Operating Companies, Investigation of Below-band Transport Rates, Memorandum Opinion and Order, 10 FCC Rcd 1573 (1994)(*GTE Below-band Investigation*).

[28] Price Cap Performance Review for Local Exchange Carriers, 9 FCC Rcd 1687, 1705 (1994) (*Notice*).

[29] *First Report and Order*, paras. 25, 368-69, 407-08, 418.

[30] *See* Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2941 (1989) (*AT&T Price Cap Order*).

caps, the LECs have the incentive to become more efficient and innovative at the same time that customers benefit from lower rates.[31]

19. Price cap regulation also discourages discriminatory pricing by LECs in favor of their own vertically integrated operations and against customers that are CAPs, dependent on specific bottleneck facilities of LECs. Given that LECs are both competitors and suppliers of CAPs, and in certain markets of the IXCs, LECs have the opportunity to "price squeeze" their competitors by raising the price of the bottleneck services and lowering the price in competitive downstream markets.[32] In the price cap system, there are four basic safeguards for controlling a price squeeze. First, the price cap system places services with high cross-elasticities of demand (competing services) in the same basket, while separating services without high cross-elasticities of demand.[33] Second, service subcategories/pricing bands prevent LECs from offsetting price decreases for competitive services with price increases for bottleneck services. Third, our rules governing the introduction of new services prevent LECs from charging anti-competitively high prices for new bottleneck services required by CAPs.[34] Finally, an aggrieved party may file a complaint charging a violation of Section 202 of the Communications Act.[35]

20. On the whole, the Commission's system has assured that interstate access prices charged by LECs generally decline in real, inflation-adjusted terms. Moreover, by grouping similar services together in service baskets subject to their own price cap and (where relevant) service categories subject to pricing bands, the LEC price cap plan deters the LECs from recouping reductions in prices for competitive services with price increases for captive services.

21. Like all price regulation, the Commission's price cap system is an imperfect substitute for actual competition. LEC price cap regulation should continue only until

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[31] *See also First Report and Order*, paras. 93-94 (stating that, in considering revisions to the price cap plan, our goal would be to replicate and stimulate competitive outcomes); *id.* at para. 94 ("as a general corollary to the goal of seeking to both replicate and stimulate competitive outcomes, we will also prefer policies and programs that minimize distortion of competitive marketplace forces in telecommunications"); *id.* at para. 406 (stating that, as we proceed to refine the price cap plan, it is our intention "that it will advance the goal of fostering an efficiently competitive local market").

[32] *See* Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection Through Virtual Collocation for Special Access and Switched Transport, Report and Order, 10 FCC Rcd 6375, 6403 (1995)(*Virtual Collocation Overhead Prescription Order*).

[33] Cross-elasticity measures the changes in demand (or supply) of commodity X when the price of commodity Y changes. A positive cross-elasticity indicates that the commodities are substitutes.

[34] *See* discussion *infra* at Section IV.B.2.b.

[35] 47 U.S.C. § 202.

competition emerges in the interstate access market. While the current price cap plan gives LECs greater incentives to operate efficiently and greater flexibility in setting rates, compared to rate-of-return regulation, it still imposes significant regulatory constraints upon carriers. Such constraints tend to become unnecessary or counterproductive as market forces become operational.

22. Price cap regulation limits the exercise of market power by the monopoly local exchange carriers, who may remain protected today from competitive rivalry by endogenous and exogenous barriers to entry. Endogenous barriers to entry are barriers erected by the incumbent firms to discourage new entrants. Endogenous barriers in certain circumstances may include building substantial excess capacity,[36] vertical integration,[37] and establishing conditions or agreements that limit a customer's ability to switch to alternative suppliers.[38] Still another endogenous barrier that is of concern to this Commission is predatory pricing.[39] Predatory pricing is defined as "deliberately pricing below cost to drive out rivals and raising the price to the monopoly level after their exit."[40] We have defined cost for these purposes

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[36] Excess capacity serves as a threat to new entrants because the incumbent can control the market price by increasing or decreasing its output. *See, e.g.*, Avinash Dixit, A Model of Duopoly Suggesting a Theory of Entry Barriers, BELL J. ECON. 20 (1979).

[37] Vertical integration makes entry more difficult because new entrants must either obtain permission from the incumbent to use essential facilities or enter the industry at the same level of integration as the incumbent in order to achieve the same economies of scope as the incumbent. Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization,* Second Edition, Harper Collins College Publishers at 806 (1994).

[38] Assuming number portability were technologically feasible, a LEC's refusal to offer it might be an example of this type of barrier. The Commission is currently considering the feasibility and desirability of requiring telephone companies to implement local number portability in a separate proceeding. Telephone Number Portability, Notice of Proposed Rulemaking, CC Docket No. 95-116, FCC 95-284 (released July 13, 1995).

[39] *See, e.g.*, Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, CC Docket No. 89-79, 7 FCC Rcd 5235, 5237 (*Second ONA Reconsideration Order*), *recon. denied*, Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, CC Docket No. 89-79, 10 FCC Rcd 1570 (1994) (*Third ONA Reconsideration Order*).

[40] W. Kip Viscusi, John M. Vernon & Joseph E. Harrington, Jr., *Economics of Regulation*, D.C. Heath and Company at 213 (1992). Courts also have defined predatory pricing as pricing below some relevant measure of cost in order to drive competitors from the market. *See, e.g.*, Southern Pacific Communications Co. v. American Telephone and Telegraph Co., 740 F.2d 980, 1002-05 (D.C. Cir. 1984), *cert. denied.* 470 U.S. 1005 (1985); *citing* Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv.L.Rev. 697 (1975); *cited in* Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 584 n.8 (1986). Previously, the Commission has concluded that requiring the price of a service to exceed the service's direct costs

as average variable cost ("AVC").[41] While actual instances of predatory pricing in the economy as a whole are generally considered to be rare,[42] some experts believe that the telecommunications industry is susceptible to predatory pricing because its market structure and production characteristics are consistent with the conditions necessary for this pricing strategy.[43] Others believe the substantial sunk costs required to enter the telecommunications industry provide protection against predatory pricing once the new entrant has constructed its plant, because if the new entrant is driven from the marketplace others can acquire these facilities and continue to provide competition.[44]

23. Exogenous barriers to entry are those that are beyond the direct control of the incumbent firm and are due to either technological limitations or government regulation. Technological barriers are frequently associated with production economies.[45] Government-imposed barriers typically consist of regulations that limit entry and exit or control rates.

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will prevent predatory pricing. *Second ONA Reconsideration Order*, 7 FCC Rcd at 5237 (para. 12); (*Third ONA Reconsideration Order*, 10 FCC Rcd at 1571 (para. 5).

[41] AVC is defined as all non-fixed costs which would not be incurred if that service were not offered. *AT&T Price Cap Order* at 3115.

[42] *See LEC Price Cap Order*, 5 FCC Rcd at 6824 ("Predatory pricing, though often alleged, is fairly uncommon, and proven cases are rare") (*citing* Areeda & D. Turner, Antitrust Law, para. 711 (1978)); R. Koller, The Myth of Predatory Pricing: An Empirical Study, 4 Antitrust Law & Econ. Rev. 105 (1971); J. Kwoka & L. White, The Antitrust Revolution (1989)).

[43] Paul L. Joskow & Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213, 219-20 (1979). Joskow and Klevorick identify several structural factors that they argue are generally required for predatory pricing to occur. The most relevant of these are: (1) the predating firm must have monopoly power and (2) there must be entry barriers. In examining entry conditions, Joskow and Klevorick suggest looking at the amount of capital required by a new firm to enter a market at minimum efficient scale; whether the dominant firm has been successful in establishing a significant "brand preference" in the eyes of consumers; whether productive resources or assets can be transferred from one firm to another; whether entry occurs through "entry point" submarkets (in which case the dominant firm could prey only in the entry point markets); and the perceptions of the risks of entry. *Id.* at 227-31.

[44] *Modern Industrial Organization* at 385.

[45] Production economies may limit entry in several ways. First, large scale operations require substantial amounts of capital before entry into the industry can take place. Second, production economies limit the number of firms that a market can accommodate. In some cases, one or two firms can meet all market demand. Finally, the amount of "sunk" or unrecoverable investment may be proportional to total investment - the larger the scale, the greater the amount of sunk costs. The risk that a firm in a market may be unable to recover substantial sunk costs discourages new entry. *Modern Industrial Organization* at 806.

24. Rate regulation may distort the prices access customers pay for services by holding them at levels that are either above or below their economic costs.[46] Prices set above the economic cost of providing service distort consumer decision-making. Above cost prices for interstate access services, for example, likely result in higher interstate retail toll prices and cause toll customers at the margin to consume other goods and services rather than to increase their use of interstate long distance services. Such prices also cause high-volume and even moderate-volume business customers to substitute dedicated facilities, which may be the local exchange carrier's special access facilities, or those of an alternative provider, even where the use of such facilities is not economically efficient, if the price of dedicated access is less than an above cost price that the customer would pay for services that use switched access.[47]

25. Prices above costs also attract inefficient service providers. Prices establish important decision-making signals for both potential (and existing) suppliers of communications services as they do for users of these services. If the prices that LECs are permitted to charge are held above the competitive level by our regulations, inefficient entry may be encouraged. Furthermore, such entry may occur in the expectation that existing price relationships will be maintained. Permitting rates to reflect costs will limit new entry to efficient providers.[48]

26. Rates that are held below costs are equally undesirable because they also can distort decision-making by potential competitors concerning entry and investment in the market. Rates in low-density markets that are held below cost by regulation can create an illusion of under-investment in communication facilities in those areas. This is because the communications users will demand more at these prices than producers are willing to offer. In addition, potential efficient entrants may be deterred by the appearance that incumbents' costs, as reflected in artificially depressed prices, are lower than their own. The existence of a *bona fide* shortage of telephone services cannot be established until prices rise to cost. Only when prices equal or exceed costs will potential entrants be able to evaluate properly the financial benefits of entering these markets. Permitting rates to rise to cost would facilitate efficient, competitive entry.

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[46] Economic costs (hereinafter "costs") reflect the current value of all the resources used to produce a product or service. The current values of resources are measured by their opportunity cost, *i.e.*, their best alternative use. *See* generally, *Modern Industrial Organization* at 56.

[47] Switched access prices that impose excessive charges on large users create an incentive for them to substitute dedicated access for switched access even if the cost the carrier incurs to provide the dedicated access is greater than the cost to the LEC of providing the switched access. Such inefficiencies are magnified in areas where there are numerous high volume toll users coupled with the availability of competing services. *NYNEX Universal Service Waiver Order*, 10 FCC Rcd 7445.

[48] *Id.*

27. The institutional structure of the industry itself may operate in combination with our access charge rate structure to contribute to suboptimal pricing. This is because the end-user generally selects the local service provider, to the extent there is any selection to be made, even though the IXC is responsible for compensating the local service provider for much of the cost of access. Furthermore, an IXC terminating a call has no choice regarding the local service provider whose facilities will be used for that purpose. This dichotomy between the service provider selection process and the compensation process may inhibit competition and delay efficient pricing for access services. Thus, it is possible that competition in the access market may develop at a different pace and in a different manner than competition in the provision of local telephone service.

28. In the *First Report and Order*, we recognized that competition in the access markets is starting to emerge. As previously stated, this Second Further Notice is a response to this development. We consider issues relating to clarifying and simplifying the introduction of services, giving the price cap LECs certain additional pricing flexibility, and revising the structure of service baskets and categories under the price cap plan. We believe these proposals will achieve the goals we have articulated herein without risking competitive harm. In this context, we define competitive harm in terms of the ability of a LEC to prevent prices paid by access customers from moving toward their efficient economic cost or to reduce the quality or range of services provided to access customers or to impose unreasonable endogenous barriers to entry. Because interstate access services are a critical input in the provision of interstate interexchange service, we also define competitive harm to include LEC actions that could affect adversely competition in the interexchange market, which would collaterally harm long distance users, such as by preventing long distance prices paid by end users from moving toward their efficient economic cost, or by reducing the quality or range of services provided to long distance users.

29. To meet our objectives of promoting competition, encouraging market-based pricing, encouraging efficiency and innovation, and permitting us to regulate efficiently and unintrusively to the benefit of consumers, we offer the following guidelines. First, we generally propose to limit the relaxation of regulation to that which will not cause competitive harm as defined herein. We expect the reforms we propose to implement within the price cap plan to benefit consumers regardless of the actual level of competition. If the potential for harm is evident, however, the grant of pricing flexibilities and other relief would be postponed until specific competitive standards are met. Pricing flexibilities and other relief that have less potential for creating harm would face a lower competitive threshold than those that are potentially more harmful. Second, we expect the pricing flexibilities that we propose here will result primarily in rate reductions. Downward pricing flexibility will permit LECs to respond to competition and rationalize rates that otherwise are inefficiently inflated. Third, we propose to eliminate price cap regulations that are no longer necessary to prevent anti-competitive behavior or promote LEC innovation or efficiency whenever doing so would not disadvantage consumers. In addition to the relief and pricing flexibility we specifically propose, we also request comment on a number of other possible forms of regulatory relief and price cap modifications.

30. We also ask for comment in Section V. of this Second Further Notice on the extent to which services should be removed from price cap regulation or subject to "streamlined" regulation, the conditions under which this should be permitted, and the best way to proceed in granting such regulatory relief. In Section VI., we ask under what conditions LECs should be deemed "nondominant" and relieved from all but the minimum statutory requirements.

31. There are a number of issues which we consider outside the scope of this Second Further Notice. First, we anticipate seeking comment on a number of specific issues regarding our long-term price cap plan in an upcoming further notice. In particular, that notice will request comment on the following: (a) the X-Factor, including calculation of the X-Factor, the number of X-Factors to be included in the price cap plan, and whether the X-Factor should be reviewed and modified periodically or set on a permanent basis; (b) the sharing and low-end adjustment mechanisms; (c) the common line formula; and (d) the exogenous cost rules. We do seek comment in Section VII.A. of this Second Further Notice, however, on whether the competition faced by a LEC should influence its X-Factor or sharing obligations. Second, we will not consider making comprehensive or substantial revisions to Part 69 of the Commission's Rules,[49] although we consider in Section IV.B. modifying Part 69 to simplify the procedures for introducing new switched access services. Finally, some changes to the price cap rules proposed here might place pressure on rates for which we do not propose pricing flexibility because such flexibility may impact the broader access charge rate structure. For example, we do not propose here that carriers be permitted to change the way they compute their end-user common line charges. We believe consideration of such changes would be more appropriate in a separate proceeding on access charge reform which we intend to initiate in the near future.

IV. REVISIONS TO THE LEC PRICE CAP PLAN

A. General

32. As explained previously, we propose a framework of LEC price cap regulation with three gradations generally reflecting increasing degrees of competition for a LEC's services. In this section, we seek comment on issues related to the first gradation of our envisioned framework: modifying the price cap system itself. We solicit comment on the second and third gradations, streamlined regulation and nondominant treatment, later in this Notice.

33. In this section, we seek comment on a number of possible changes to our LEC price cap rules. These fall into three basic categories: (1) simplifying treatment of new

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[49] *See First Report and Order*, para. 416.

services and innovative tariff offerings, including alternative pricing plans ("APPs");[50] (2) granting price cap LECs certain additional pricing flexibility, including the offering of APPs such as volume and term discounts and eliminating the lower SBI limits; and (3) changing the price cap service basket and category structure. Each modification of the price cap plan is described in Part B.

34. We propose that the changes we describe herein generally be effective without regard to the current level of competition. Because we believe these proposals will facilitate more efficient pricing by LECs and remove incentives for inefficient entry, we tentatively conclude that they need not be conditioned on a competitive showing. Alternatively, these changes could be made effective only upon a showing that barriers to competition have been removed. In Part C, we discuss several potential criteria that could be used to determine whether markets are open to competition to an extent that would justify affording the LECs the proposed regulatory relief if we conclude that a proposal should not be implemented without consideration of current market conditions. In those situations in which a commenter recommends requiring some demonstration that barriers to competition have been removed prior to making a change or granting some specific relief or pricing flexibility, the commenter should explain why current market conditions require that relief or flexibility be conditioned upon such a showing. The commenters should also discuss the evidence that should be required, how the Commission could verify such demonstration, and the causal nexus between the recommended showing and the relief at issue. For example, what threat to competition would be engendered by allowing the proposed change without a demonstration that no barriers to competition exist? How would the recommended competitive test alleviate this threat? Conversely, commenters supporting our proposal should explain why affording LECs a certain type of relief or pricing flexibility before they have demonstrated some level of actual or potential competition would not create an unreasonable risk to competition or consumers.

35. Adopting competitive standards requires a definition of competitive markets to which the standards apply. In Part D, we propose definitions of geographic and product markets for purposes of measuring competition and defining the area in which we would grant any relief that we decide to make contingent on a finding of a competitive market. Market definitions are also necessary for streamlining and non-dominance determinations. We propose to use the same market definitions in Section V (Streamlined Regulation) and Section VI (Non-dominance).

36. Comments on the price cap modifications, the competitive "triggers," and the market definitions should address, among other things, the expected impacts on the prices, innovation, short-term and long-term growth of competition, and efficient investment in and use of telecommunications services and facilities. In addition to commenting on the

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[50] As discussed *infra* at Section IV.B.2.c., we seek comment on whether to define APPs as services that are self-selected optional discounted rate plans for a service that currently exists.

individual rule changes we propose below, we request commenters to consider the implications of adopting various of these rule changes in combination with one another. In other words, we seek comment on the likely cumulative effect of these proposed changes in addition to the impact of particular proposals in terms of their potential effects with respect to our regulatory goals. To the extent that states have implemented price caps and other flexible regulatory structures, we would be interested in receiving comments concerning the experiences in those states as they relate to the issues in this Second Further Notice.

B. Proposed Modifications to the Price Cap Plan

1. Introduction

37. In this Section, we seek comment on clarifying and relaxing certain tariff and waiver requirements for the introduction of certain service offerings, allowing LECs additional pricing flexibility, and changing the existing service basket and category structure under the price cap rules. We believe these changes to the price cap rules will encourage LECs to introduce innovative services, enable them to do so expeditiously under clearly defined procedures, and enable them to move prices closer to cost because doing so will replicate the results of a competitive market. As we consider the possible changes discussed in this Notice, we do not want to relax regulation so much that consumers will be harmed by monopoly pricing or allow LECs so much pricing flexibility that they could recoup foregone revenues from more competitive services with revenues from less competitive services, or engage in predatory pricing, unlawful discrimination, or other anticompetitive practices.

2. Implementation of Service Offerings and Rate Changes

a. Introduction

38. We propose to clarify or modify the definitions of new services, restructured services, and individual case basis (ICB) filings and the filing requirements relating to each type of service offering. We also seek comment on whether to introduce a new category of service offering, alternative pricing plans (APPs), with separate filing requirements. The modified filing requirements we propose for new services, restructured services, ICBs, and APPs would apply unless the Commission has established special, specific guidelines for filing tariffs and introducing a rate structure for a particular service (as we have, for example, for expanded interconnection and video dialtone).[51] We are concerned about the

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[51] *Virtual Collocation Order*, 9 FCC Rcd at 5189 (para. 128); *Virtual Collocation Overhead Prescription Order*. In expanded interconnection, we required carriers to show that they do not recover a greater share of overhead loadings from expanded interconnection charges than they do for the charges for comparable services. With respect to video dialtone service, the Commission found that LECs have an incentive to understate their direct costs, to set unreasonably low prices and engage in cross-subsidization. Accordingly, the Commission required each LEC to include all its incremental costs associated with plant dedicated to video dialtone as direct costs, in addition to a reasonable

delay and burden that our current rules may cause in introducing new services. Further, many "new" services may actually be optional discounted versions of existing services. We are concerned that the current system may hinder the introduction of services, a result that is harmful to customers and competition. We believe the changes we propose will allow for more efficient and expeditious introduction of new services, and encourage innovation, consistent with the public interest.

b. New Services and Restructures

39. We propose in this Notice to modify the rules relating to the treatment of new services either now or in the future as competition develops so as to allow price cap LECS to introduce certain new services under a relaxed regulatory framework. We propose shortening the notice requirements for restructured services and to revise the definition of new services to exclude APPs. These proposed changes are intended to encourage the prompt introduction of new tariff offerings, while maintaining an appropriate level of regulatory oversight.

40. By way of background, new services are currently defined as services that add to the range of options already available to customers.[52] Under the existing rules, a new service may include, but need not, a new technology or functional capability; the test is simply whether the service adds to the existing array of services.[53] New services are distinguished from "restructured" services, which replace existing services and consequently do not expand the range of services available.[54] Under the current rules, a new option that is functionally indistinguishable from an existing service but is offered under different rates, terms, and conditions (an APP as we propose to use the term) is treated as a new service and is subject to the same regulatory requirements that apply to new services that are different from existing service offerings.

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allocation of other costs associated with shared plant used to provide video dialtone and other services. Furthermore, it required LECs to provide a strong justification for allocation of extremely low overhead costs to video dialtone service. Telephone Company-Cable Television Cross Ownership Rules, Section 63.54-63.58, CC Docket No. 87-266, 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, RM-8221, 10 FCC Rcd 244, 344-46 (paras. 216-20) (1994) (*Video Dialtone Order*). But *cf.* US West Communications, Inc., Tariff F.C.C. No. 5, Market Trial of Basic Video Dialtone Service in Omaha, Nebraska (Com. Car. Bur., released Aug. 30, 1995)(approval of cost allocation methodology for market trial that differs from methodology prescribed in *Video Dialtone Order*).

[52] *LEC Price Cap Order*, 5 FCC Rcd at 6824 (para. 314).

[53] *LEC Price Cap Order*, 5 FCC Rcd at 6824 (para. 314).

[54] New services and restructures are both distinguished from a mere change in the rate for an existing service.

41. Under current rules, new service tariff filings must be made on at least 45 days' notice[55] and be accompanied by detailed cost support. Specifically, a LEC introducing a new service is required to submit cost studies to identify the direct costs of providing the new service, absent overheads. The LEC must use a consistent costing methodology for direct costs for all related services.[56] The LEC may, but does not have to, add a level of overhead costs to the direct costs to support the proposed price of the new service. Uniform overhead loadings are not required, but the LEC must justify its methodology for determining overhead loadings and any deviations from the methodology.[57] In cases where a LEC develops a lower-cost version of an existing service, it may employ non-uniform overhead loadings if necessary for the LEC to break even in providing the service.[58] Further, non-uniform overhead loadings are presumptively reasonable whenever a LEC uses them to justify the introduction of a new service at a level below the imputed "old" price of a close substitute service.[59] The new services test thus places a flexible, cost-based upper bound on the prices of new services offered by LECs under price cap regulation. The requirement that prices exceed a direct cost showing also establishes a price floor for new services,, ensuring

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[55] Section 61.58(c)(5) of the Commission's Rules, 47 C.F.R. § 61.58(c)(5); *LEC Price Cap Order*, 5 FCC Rcd at 6825 (para. 320).

[56] Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, CC Docket Nos. 89-79 and 87-313, 6 FCC Rcd 4524, 4531 (para. 42) (1991) (*Part 69 ONA Order*), *modified on recon.*, 7 FCC Rcd 5235 (1992); *further recon. denied*, 10 FCC Rcd 1570 (1994). Cost support accompanying a LEC new service tariff filing must include, in part, a study containing a projection of costs for a representative 12-month period and estimates of the effect of the new service on traffic and revenues. *Part 69 ONA Order*, 6 FCC Rcd at 4531 (para. 42). As part of the justification for the price selected for the new service, LECs may include a "risk premium" on investments in unusually risky new services. *Part 69 ONA Order*, 6 FCC Rcd at 4531 (para 43). A risk premium is defined as the additional rate of return a LEC needs to justify the development of a particularly risky new service. *Second ONA Reconsideration Order*, 7 FCC Rcd at 5237 (para. 13).

[57] *Part 69 ONA Order*, 6 FCC Rcd at 4531 (para. 42).

[58] Requiring uniform overhead loadings for close substitute services in some cases may force the LEC's revenues to a level below what it would receive if it did not offer the new service. *See Second ONA Reconsideration Order*, 7 FCC Rcd at 5236 (para. 9); *Third ONA Reconsideration Order*, 10 FCC Rcd at 1571 (para. 5).

[59] *Second ONA Reconsideration Order*, 7 FCC Rcd at 5237; *Third ONA Reconsideration Order*, 10 FCC Rcd at 1571 (para. 5).

that prices are not predatory.[60] As discussed above, the Commission has also adopted special rules for video dialtone service and expanded interconnection collocation tariffs.[61]

42. In addition, each new service is initially held outside the LEC's price cap indexes for at least six months, and is incorporated into the relevant index in the first annual price cap tariff filing after the completion of the base year in which the new service becomes available; *i.e.*, 6 to 18 months after the tariff takes effect.[62] We adopted this procedure in part to encourage LECs to develop innovative new services.[63] We also found that excluding new services from price cap regulation for a period of time is necessary to enable LECs to develop historical data, so that the new service can be incorporated into the LEC's price cap indexes based on actual data, rather than the 12-month projections included in its initial cost support.[64] The use of historical data helps ensure that the service will properly be incorporated into the plan in a manner that protects the public interest.

43. The tariff filing and other requirements currently applicable to restructured service offerings differ from those applied to new services. Restructured service offerings must be filed on 45 days' notice and no cost showing is required. Rather, LECs are required to show only that the rates for the restructured service fall within their existing PCI, and the actual price indexes (APIs) and SBIs must be recalculated.[65] Further, restructured services are incorporated into the applicable price cap basket immediately upon effectiveness of the tariff.

44. In the comments submitted in response to the Phase I Notice in this proceeding, several LECs argued that the new service rules are unreasonably time-consuming and burdensome, and may impede the development and introduction of new services.[66] We decided not to consider revising the new service rules in the *First Report and Order*, so that we could address this issue in conjunction with issues raised by other revisions to the price

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[60] *Second ONA Reconsideration Order*, 7 FCC Rcd at 5237; *Video Dialtone Order*, 10 FCC Rcd at 343.

[61] *Video Dialtone Order*, 10 FCC Rcd at 344-46 (paras. 216-20); *Virtual Collocation Order*, 9 FCC Rcd at 5189 (para. 128); *Virtual Collocation Overhead Prescription Order*.

[62] *LEC Price Cap Order*, 5 FCC Rcd at 6825 (para. 319).

[63] *LEC Price Cap Order*, 5 FCC Rcd at 6825 (para. 318).

[64] *LEC Price Cap Order*, 5 FCC Rcd at 6825 (para. 319).

[65] Section 61.49(f) of the Commission's Rules, 47 C.F.R. § 61.49(f); *LEC Price Cap Order*, 5 FCC Rcd at 6826 (para. 325).

[66] *See First Report and Order*, paras. 398-402.

cap plan to be made in response to the emergence of competition.[67] We seek to eliminate unreasonable restrictions or undue delays that our current rules may impose on LECs' ability to introduce new offerings. We also seek to make our procedures governing the introduction of new service offerings more efficient and certain.

45. We propose that LECs be allowed to introduce certain new services on shorter notice and with less cost support than our current rules require for new services. We propose that new services be divided into two categories, known as "Track 1" and "Track 2" services. Track 1 new services would remain subject to current notice, cost support and other requirements. Track 2 new services would be subject to reduced notice and cost support requirements.

46. As a preliminary issue, we must determine the new services that should remain subject to Track 1 treatment. We see at least two general options for making this determination. A first option would be to treat all new services in a relevant market as Track 1, until the LEC has made some kind of demonstration that its competitive circumstances warrant the relaxed Track 2 regulatory relief. (Issues related to these "triggers" are discussed in Section IV.C., below.) A second option would be to establish a test to distinguish between new services that warrant higher scrutiny from those that warrant a lower level of scrutiny, based on the nature of the services themselves. Those services requiring less scrutiny because they raise no competitive implications (based on a standard such as we propose below) would be afforded Track 2 treatment regardless of the level of competition the LEC actually faces for those or other services. We invite interested parties to comment on both approaches. In particular, we seek comment on the approach that would enable us to focus our attention on new services that need closer review, without becoming administratively burdensome.

47. If we adopt the second definitional approach and base the definitions of Track 1 and Track 2 on the nature of the new services themselves, we would need to establish those definitions. As a starting point, we would propose to include as Track 1 services any services that the Commission requires LECs to offer. An example of a service that we require LECs to offer is expanded interconnection[68] (although we note that expanded

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[67] *First Report and Order*, para. 415.

[68] *See, e.g.*, *Virtual Collocation Order*, 9 FCC Rcd 5154. We required all Tier 1 LECs, except members of National Exchange Carrier Association (NECA) pools, to provide expanded interconnection service. Puerto Rico Telephone Company is the only Tier 1 carrier participating in NECA pools. *Special Access Expanded Interconnection Order*, 7 FCC Rcd at 7398 (para. 57). Tier 1 LECs are those earning $100 million or more per year from regulated telecommunication operations. Section 32.11 of the Commission's Rules, 47 C.F.R. § 32.11. In the provision of expanded interconnection, LECs permit competitors and access customers to terminate their own basic transmission facilities at LEC central offices and to interconnect with LEC special access or switched transport facilities. *See* Sections 64.1401(d), (e), and (f) of the Commission's Rules, 47 C.F.R. §

interconnection is currently subject to special pricing requirements in addition to the basic new services test rules, and we do not propose to modify those requirements).[69] A second possible category of services we might consider as Track 1 is services essential to a LEC's competitors. Expanded interconnection is also an example of a service that we would consider essential to a LEC's competitors. We consider expanded interconnection essential to a LEC's competitors because it enables those competitors to offer transmission segments that can substitute for the previously bundled segments offered by the LECs.[70] This facilitates competitive entry into the markets for special access and switched transport services in an environment where LECs control essential facilities. A possible alternative to this "essential services" test might be a "close substitutes" test. Under this alternative, Track 1 services would include services that are not "close substitutes" for an existing service, within the meaning of the *Second ONA Reconsideration Order*.[71] A new service would be considered a close substitute for an existing service or a group of existing services when a carrier can show that it reasonably expects customers of those existing services to migrate to the new service.[72] The rationale for this possible approach is that the absence of a close substitute to which a LEC customer could turn warrants more careful regulatory review of the new service to ensure that other providers can effectively compete with the LEC. We solicit comment on these definitions, and invite parties to suggest other possible definitions for Track 1 services that would help us identify offerings that may have a significant effect on the competitive marketplace we desire to see established. It is important that any definition be easy to administer. Thus, commenters should explain, for example, how any proposed distinctions in services would provide a "bright line" test for distinguishing Track 1 from Track 2 services, and how any proposals would reduce the regulatory burden for all concerned.

48. If we adopt the definitional approach and distinguish between Track 1 and Track 2 based on the nature of the service itself, then we propose to delegate to the Common Carrier Bureau the authority to determine whether a particular new service should be

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64.1401(d), (e), (f). Tier 1 LECs are required to offer expanded interconnection through "virtual collocation," which would permit an interconnector to designate or specify equipment needed to terminate basic transmission facilities to be located within or upon the LEC's central offices and dedicated to that interconnector's use, unless the LEC and the interconnector agree to a physical collocation arrangement. Under physical collocation, an interconnector would be permitted to place its own equipment needed to terminate basic transmission facilities in the LEC's central office. *See* Section 64.1401(c) of the Commission's Rules, 47 C.F.R. § 64.1401(c).

[69] *Virtual Collocation Order*, 9 FCC Rcd at 5185-91; *Virtual Collocation Overhead Prescription Order*.

[70] *Virtual Collocation Order*, 9 FCC Rcd at 5159 (para. 9).

[71] *Second ONA Reconsideration Order*, 7 FCC Rcd 5235.

[72] *Second ONA Reconsideration Order*, 7 FCC Rcd at 5237 (para. 11) and n.18.

classified as Track 1 or Track 2 under definitions established by the Commission. For example, price cap LECs seeking Track 2 treatment for a new service could submit a petition prior to filing its tariff explaining why Track 2 treatment is warranted. The petition would be deemed granted on the 10th day after it is filed unless the Bureau notifies the carrier that its request is denied on or before the 10th day. Parties opposed to the classification of a new service as Track 2 would have the opportunity to object within that framework. We invite parties to comment on this proposal, and to recommend other possible procedures that would enable us to determine whether a new service warrants Track 1 or Track 2 treatment without creating excessive administrative burdens for the Commission or the industry.

49. We propose retaining the existing notice and cost support requirements for Track 1 new services.[73] For Track 2 new services, we propose reducing the notice requirement to 14 days, but invite comment on whether a longer or shorter period would be preferable and, if so, why. We also propose with respect to Track 2 services to require carriers to show that the new service rates will recover the direct costs of providing the service as we currently do for new services, and to eliminate all other currently required cost support requirements for these services, except if the Commission has prescribed special, specific cost and other filing requirements relating to the type of service concerned. If the Commission has adopted such special cost and other rules, as it has, for example, with respect to expanded interconnection and video dialtone, then these specific requirements would be followed in lieu of the rules we are proposing. We believe that under the relaxed rules we are proposing, the direct cost showing and the definition of Track 2 services will be adequate to ensure that the offering of such services will not have anti-competitive effects.

50. Unlike the new services test, the filing support requirements for restructures do not seem to raise the same potential for chilling innovation or hindering responsiveness to the marketplace. The filing support requirements for restructured service offerings are minimal. Thus, we propose to retain our current cost support filing requirements for restructured services and invite comment on this proposal. Parties that support changing these requirements should suggest specific modifications.

51. It may not be necessary to retain the current 45-day notice requirement for restructures. We originally adopted a 45-day notice requirement rather than 14 days because we were concerned that it would not be possible to address issues of unreasonable rate levels or discriminatory pricing in 14 days.[74] As the competitive circumstances faced by LECs increase, unreasonably high restructured rates become less likely, and thus a notice period of

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[73] Sections 61.49(g) and 61.58(c)(5) of the Commission's Rules, 47 C.F.R. §§ 61.49(g) and 69.58(c). Of course, the Commission can specify different notice and cost support, as well as other special requirements such as overhead loading specifications, for any service it deems of special concern. *See, e.g.*, *Video Dialtone Order*, 10 FCC Rcd 244; *Virtual Collocation Order*, 9 FCC Rcd at 5189.

[74] *LEC Price Cap Order*, 5 FCC Rcd at 6826 (para. 324).