Likewise, the aggregate price cap experience of the first four years shows that voluntary LEC price reductions have had only a minimal effect on the overall performance of the FCC plan. The First Report and Order in this proceeding identified some $5.8 billion in price reductions over the cumulative four-year period. Only about $1.08 billion or 18% of these economic effects were attributed to unused LEC "headroom."[8] The total unused "headroom" amounted to less than 1.9% of the price cap LECs' cumulative interstate access service revenues (about $57.5 billion) during the first four years of the plan.[9] In other words, most of the lower pricing flexibility provided in the initial price cap plan remains, in effect, unused headroom. In the First Report and Order, the Commission doubled the allowable downward pricing flexibility for the Traffic Sensitive and Trunking baskets and lowered the annual price floor for zone-density priced offerings to 15%.[10] The LECs' current (but unused) pricing flexibility is thus substantially greater than during the first four years of the price cap plan.

The LECs' failure to utilize all of the potential downward flexibility available to them is not evidence of a regulatory failure. The LECs' behavior is also entirely rational. Nevertheless, the evidence undercuts the notion in the Pricing Flexibility Notice that offering the LECs additional capacity to reduce prices without regard to competition will lead to altruistic price reductions: "Downward pricing flexibility will permit LECs to respond to competition and rationalize rates that otherwise are inefficiently inflated."[11] Only the first of these objectives, responding to competition, is a real marketplace phenomenon.

---

[8] First Report and Order, Appendix C, p. 6.

[9] Source, FCC "Statistics of Common Carriers," 1991 to 1993 and annual filings for 1995, excluding any revenues for current price cap LECs for years prior to their election of price caps.

[10] See Pricing Flexibility Notice, paragraph 13.

[11] Pricing Flexibility Notice, paragraph 29.

While the LECs may eventually feel compelled by market pressures to reduce "inflated" prices, the Commission cannot create a priori a workable regulatory incentive structure to encourage this behavior. In particular, the Commission, or any other government entity, is ill suited to identify and distinguish between rate reductions that are intended to signal potential competitors to reduce their market entering activities, versus rate reductions that are unambiguously efficient. The Commission lacks the information needed to identify possibly "inefficient entry" by potential competitors.

These are all tasks for the marketplace itself. A rational competitor should check its market entry expectations against economic costs rather than mere prevailing prices. It would attempt to determine whether its expected marginal costs were no higher than the incumbent carrier's marginal costs. For the Commission to try to independently duplicate this assessment, however, would require information about both the entrant's and the incumbent's economic costs that was at least as good as the firms' own information. The Commission's efforts to obtain such internal economic cost information would be time consuming, complex and could require potentially competing firms to disclose sensitive information. It is unlikely that the Commission could do a better job of policing against "inefficient entry" than potential entrants can themselves.

The Commission is also poorly positioned to try to identify specific pricing actions by incumbent LECs that are classically predatory in their effect. The Commission has already recognized the possibly of predatory activities, particularly where firms like incumbent LECs also control essential inputs used by their competitors:

> While predation may be infrequent, under certain market conditions it may be a profitable strategy.... A monopoly provider of an essential service to a rival can subject its rival to a "price squeeze." Since the interconnector is both customer and competitor of the LEC, an interconnector's price for the service it provides to retail customer depends on the price at which the LEC sells bottleneck facilities that are the critical productive inputs for the interconnector...Raising rivals costs can be a profitable and inexpensive

> strategy for vertically integrated firms that control essential facilities needed by its rivals.[12]

However, the actual information needed to identify such pricing strategies is difficult to acquire in particular cases.

Ordover and Saloner comment that it is difficult, as a general matter, to distinguish among types of predatory, limiting actions, or to discern from the behavior of a firm whether an activity impairs or promotes social welfare.[13] In the case of interstate access services, however, it may be virtually impossible for the Commission to independently identify welfare enhancing versus predatory price reductions under a regime with unlimited pricing flexibility, for at least four reasons.

First, it is widely recognized that some interstate access prices involve severe distortions. The Commission is not proposing the address some of the most severe distortions at the present time.[14] Additionally, such existing distortions as the fixed recovery of non-traffic sensitive costs from interstate access services are at best likely to be gradually sifted out of interstate prices by market forces over time, rather than being abruptly eliminated by regulatory fiat. Therefore, price cap LECs may find it more

---

[12] Local Exchange Carriers' Rates, Terms and Conditions for Expanded Interconnection Through Virtual Collocation, Report and Order, CC Docket No. 94-97, Phase I (FCC 95-200), May 11, 1995. ("Virtual Collocation Refund Order") paragraphs 70-71 and footnote 147, citing, among others: Ordover and Saloner, "Predation, Monopolization and Antitrust" in Schmalensee and Willig, eds. Handbook of Industrial Organization, 537, 550-562 565-570 and 590 (game theory 'has been effective in debunking the comfortable proposition that predatory conduct is more costly to the predator than to the prey'). See also, paragraph 65 noting that LECs may "use high overheads to raise the prices of essential services needed as inputs by their competitors, while simultaneously using low overheads to reduce prices of services sold in competition with those rivals.."

[13] Ordover and Saloner, footnote 10 above, at pp. 538-538. See also, R. Schmalensee, "Standards for Dominant Firm Conduct," MIT Working Paper 1723-85 (1985).

[14] See Pricing Flexibility Notice, paragraph 31.

rational to price in a predatory manner if they have unlimited pricing flexibility, when faced with evolutionary and asymmetrical interstate access pricing reforms.

Second, interstate access rates have been set at fully allocated costs, both under rate base regulation and in the rate levels used to initialize the LEC price caps. While the Commission has adopted an average variable cost (AVC) standard to evaluate new services proposed by price cap LECs, many of the detailed aspects of AVC methodologies — the subject of lengthy and detailed state regulatory investigations[15] — have not been formally addressed by this Commission. In other words, the Commission lacks both the experience and the dataset needed to comprehensively address whether rates for particular services are set at, or, in fact, below average variable costs. This condition may tempt a price cap LEC to engage in predatory pricing under a regime of unlimited downward pricing flexibility absent other checks.

Third, whatever experience the Commission has gained from the operation of the price cap regime for AT&T,[16] is likely to be of little value with respect to the price cap LECs. As the Commission has recognized, the LECs control essential facilities used as inputs by potential competitors. By the time price caps were implemented for AT&T, the carrier did not provide any essential, non-substitutable facilities for its interexchange competitors.

Fourth, the Commission's rules regarding overhead loadings to LECs' direct costs already permit the carriers to vary prices for essentially equivalent services across a wide

---

[15] For example, the Oregon Public Utility Commission's investigation of the incremental costs of network building blocks in Docket UM 351, considered a ground-breaking effort to identify economic costs, has been underway for more than three years.

[16] See for example, the discussion at paragraphs 56-57 of the Pricing Flexibility Notice, regarding the treatment of basket headroom for AT&T and proposing similar rules to AT&T's treatment with respect to alternative pricing plans (APPs)

range of competitive discounts. The Commission recognizes that LECs have substantial discretion with respect to the size and allocation of overhead loadings.[17] While the Commission recently required some LECs to reduce overhead loadings deemed to be excessive, the range of loadings that were permitted ranged from 0% to over 30% on many rate elements.[18] These percentage ranges are large enough to allow LECs to engage in substantial price discounting merely by varying the overhead loading factors. In fact, price differences up to 30% represent typical established telecommunications services discounts in competitive markets. MCI, for example, discounted its rates about 20% below AT&T's long distance MTS rates prior to full interexchange equal access, and LECs in various states have implemented or proposed to implement tariffs with competitive discounts of 20% to 30%. Thus, the Commission's existing policy allowing highly-variable overhead loadings already provides price cap LECs with significant marketplace price leverage.

In addition to the effects of the current access rules, the literature on predatory pricing, analyzed in some detail in the survey cited by the Commission,[19] provide a number of reasons why, as LECs move away from mere pre-competitive pricing of interstate access services, some of them may adopt predatory pricing strategies.

For example, predatory strategies are more attractive if the firm believes that its overall costs of predation can be recouped from higher profits elsewhere. While one cannot assert without qualification that all price cap LECs expect to realize higher profits overall from interstate access services, the majority of the existing LECs have revealed preferences suggesting that they expect their profits to increase. In the first phase of this

---

[17] Pricing Flexibility Notice, paragraph 41.

[18] Expanded Interconnection Through Virtual Collocation, Report and Order, CC Docket No. 94-97 (Phase I), May 11, 1995, Appendix C, Rate Adjustment factors.

[19] Footnote 12, above.

proceeding, all of the price cap carriers argued that the Commission should actually reduce the initial 3.3% annual X-factor. However, when the Commission adopted three different X-factors ranging from 4.0% to 5.3%, five of the seven Bell companies opted for the highest offset in order to be spared the obligation of sharing future earnings, an obligation they would have retained by selecting a lower value. This behavior reveals the carriers' internal assessment that the value of their additional, unshared profits will exceed the nominal reduction in earnings associated with adopting the highest X-factor.

The LECs' revealed preference for higher, non-sharable earnings allows the Commission to infer the existence of the condition in which predatory pricing may be economically attractive to some LECs. If an LEC's expected future earnings are increasing more than the value of the higher X-factor, its possible choices of predatory pricing strategies for services that may be most susceptible to competitive entry will not be constrained merely by the size of the offsetting earnings reductions.

Indeed, the very proposals outlined in the Pricing Flexibility Notice may be interpreted by some LECs as providing an environment that is conducive to predatory pricing. The Commission's view that it could induce firms to make altruistic price reductions without regard to competition — while incorrect — establishes a potential LEC defense against predatory pricing claims. In addition, the very expectation that emerging competition will lead the Commission to move to its proposed second and third levels of pricing flexibility, may tempt predatory pricing in the near term. A firm's expectation that it will be subject to looser price regulation in the future is a factor that increases the firm's preference for a predatory pricing strategy, compared to the case where no price regulation was applied.[20]

---

[20] See Brock, "Pricing Predation and Entry Barriers in Regulated Industries" in Breaking Up Bell, edited by D. S. Evans (1983).

Studies of predatory pricing demonstrate a connection between such pricing strategies and the ability of a firm to price discriminate. Price discrimination reduces the predatory pricing penalty incurred by firms with large initial market shares, like the price cap LECs. The more the firm can discriminate the more it can isolate the part of its product set that is not subject to competition. Targeted prices can be set at lower levels than would be economically attractive to the firm if all similar products were required to share the reduced prices across all products indiscriminately.

Investigating possibly unreasonable LEC price discrimination already occupies substantial Commission time and resources. Indeed, in the Phase II designation order in the Virtual Collocation Tariff Investigation has attempted to require the LECs to provide costs and prices for their retail service offerings comparable to charges for interconnector equipment, cable installation and other costs.[21]

The sheer number of pricing options discussed in the Pricing Flexibility Notice signal LECs that they can expect to enjoy more avenues of approved price discrimination for interstate access services both in the near- and longer-term. The Notice proposes many potential forms of additional price discrimination, such as differentiating Track 1 and Track 2 new services filings,[22] and proposes potentially separate short-run pricing flexibility for alternate pricing plans.[23] The point here is not to argue against increased pricing flexibility options or reduced tariff filing notice periods for some services. But the larger the sheer number of such options made available to price cap LECs as a whole,

---

[21] CC Docket No. 94-97, Phase II; paragraphs 21, 34 et. al. Somewhat telling is the LECs apparent refusal to provide comparable cost and pricing data for retail services that provide the same technical functionality as the services subject to the investigation. See Response of the Association for Local Telecommunications Services to Phase II Direct Cases, November 9, 1995, pp. 5-6; and 18-20 and LEC direct cases cited therein.

[22] Pricing Flexibility Notice, paragraphs 45-46.

[23] Id., paragraphs 54-60.

the more likely it is that the ability to price discriminate in this manner will entice predatory strategies by some LECs.

To summarize, there are at least four aspects of the interstate access rules themselves that may encourage predatory pricing. These include the well recognized distortions in the current system, the absence of a detailed AVC methodology for tariff filings, and the Commission's current policy concerning variable overhead loadings. Likewise, the preferences of most price cap LECs for higher X-factors and higher nonsharable earnings, as well as the very promise of increased future price discrimination, provide conditions recognized in the literature as favoring predatory pricing strategies. The literature also evaluates a firm's potential preference for predatory price signalling compared to other strategies to meet market entry. Here, too, conditions favor some LECs' use of predatory strategies. Once price cap LECs do perceive a need for pricing responses to competition, predatory price signalling may be one of the incumbents' few remaining strategies for maintaining their market share.

Other dominant firm strategies for deterring market entry involve increased strategic innovation, imposing technical restrictions on rivals, or increased integration into the markets where the potential entrant(s) already operates.[24] None of these strategies is likely to available to price cap LECs, who may find themselves unable to engage in non-price limiting behaviors.

[24] When dominant firms control essential facilities, as in networked industries, initial attempts to defeat competition are more likely to involve the terms on which the essential facilities are made available, rather than overt predatory price signalling involving retail outputs.. This was the case as competition began in earlier equipment and long distance markets, when incumbents engaged in protracted "negotiations" with potential entrants and regulators over such things as protective connecting arrangements, access functionality limitations and so on. Today, by comparison, similar games proceed over the price, terms and conditions for virtual collocation and other interconnection requirements. Only when regulators resolve the issues involving the prices and terms of these dominant LEC interconnection requirements would an incumbent consider predatory price signalling through its retail service rates.

- First, incumbent LECs are most unlikely to be able to limit entry by means of accelerated product innovation. Smaller entrants are likely to be as innovative and perhaps even more adaptive to changing market conditions than the large multi-state LECs. The very size of the price cap LECs makes rapid innovation an unattractive strategy for deterring competitors.

- Second, limiting market entry by means of technical restrictions would also be highly problematic for an LEC. Over time, incumbent LECs and market entrants will utilize similar facilities and equipment, provided by many worldwide manufacturers, under increasingly precise technical compatibility specifications. Predatory technical interconnection requirements that depart from global technical standards should be readily detectable, and thus unattractive as a LEC strategy.

- Third, although dominant incumbent LECs will attempt to forward integrate in downstream markets such as toll services or information content as a way of limiting competitive entry, their rivals will be able to do the same thing. Various telecommunications service suppliers will also be trying to integrate into the LECs core markets. While the price cap LECs may enjoy some advantage in terms of their reputation in their home service territory, that reputation is unlikely to carry as much weight in other geographical areas or in services the LECs have not previously offered. Incumbent LECs are unlikely to limit entry simply by offering one-stop shopping or other strategies that do not involve any predatory price signalling.

Therefore, in telecommunications, sending pricing signals to potential market entrants may be the best strategy open to some LECs, and the possibility must be recognized that some of the resulting pricing actions likely will be predatory.

It is fair to conclude that the Commission lacks the resources or institutional support to be able to screen out any such predatory behavior on a case by case basis. Some of the more complex rules or more precise economic judgments contemplated in the Pricing Flexibility Notice could actually detract from the Commission's ability to enable pricing flexibility, prevent predatory pricing behavior and make the most efficient use of its resources. For example, judgments concerning the relative substitutability among products that would define relevant product markets,[25] are extremely difficult to make in the absence of solid, well-established data on cross elasticities among telecommunications services. Merely trying to devise rules regarding market definitions and degrees of substitutability would be time-consuming, complex and probably unproductive in the final analysis.

Experience teaches that the most effective rules are often the simplest. In practice, the implementation issues raised by a policy (whether in business or government) are typically several times more complicated and time consuming than they seem to be when the policy is first enunciated. This rule has been proven by almost every attempt to simplify FCC rules, including the progressive development of price caps. Policy issues that are remanded to "tariff review" or "complaint enforcement" typically are never definitively resolved and typically are overtaken by real or imagined changes in underlying conditions.[26] Therefore, the Commission should adopt relatively simple rules with respect to allowing price cap LECs additional flexibility.

---

[25] See Pricing Flexibility Notice, paragraphs 35 and 117 to 119.

[26] While the communications industry changes rapidly, a good number of forecast major "new waves" relied upon to induce regulators to reopen policies over the last 15 years, from photonic switches to high definition television, have typically taken much longer to develop than policy makers are initially led to believe.

## Conclusion

If (a) additional pricing flexibility for price cap LECs is inevitable (indeed, desirable) as competition increases, but (b) at least some LECs will have very rational incentives to engage in predatory price signalling, what is the Commission to do?

Rather than devise more detailed average variable cost tests and try to obtain other information to independently assess LEC pricing behavior under increased flexibility, the Commission should structure the pricing requirements so that LECs conform their prices to efficient, non-predatory levels by virtue of the incentives built into the pricing flexibility rules. If such structural incentives adequately control most LEC predatory pricing behavior, LEC pricing flexibility can be increased over time without highly detailed, independent cost analysis by the Commission.

Even the first level of additional downward pricing flexibility should depend upon some sort of competitive trigger, contrary to the Commission's tentative inclinations. Such a trigger only recognizes market realities, i.e., the absence of economic incentives for LECs' to engage in altruistic price reductions. The fact that the LECs have been ubiquitous, monopoly providers for decades provides the Commission with easily accessible data to design competitive triggers. Market entrants must interconnect with LECs in order to compete with them. Changes in the number of such interconnections with the LEC's ubiquitous network must be tracked by both LECs and entrants for billing purposes. New data is not required. Changes in the number or percentages of interconnections provide direct evidence of the growth of competition.

For example, if the rate of growth in interconnections between entrants and incumbent LECs levels off or declines it will mean either that competition is maturing (i.e., entrants are making relatively more interconnections with each other and thus the growth rate in

connections with the dominant LEC is declining) or that competition may not be taking root (i.e., the number of interconnections falls off due to some entrant's exiting the market). Either indication is pertinent and can be obtained from the available data. Thus, the Commission should identify simple competitive triggers and apply them at each possible successive level of added pricing flexibility, including the threshold downward flexibility discussed in the Notice — albeit with a trigger involving a less rigorous competitive penetration than either of the other two levels.

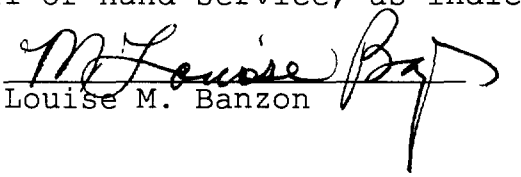
Most of the proposed pricing flexibility mechanisms, including all of the proposed "Track 2" services, any alternative pricing plans (APPs) and services that are already subject to geographic pricing flexibility should eventually be contained in a common basket. The Commission should remain relatively indifferent to the precise form of price reduction that an individual price cap LEC selects, e.g., whether the LEC uses APPs, introduces more of the services defined as Track 2, or utilizes one of the several other pricing forms discussed in the Notice. Grouping these services together with reduce the possibility that a LEC will select a combination of pricing vehicles that permits unreasonable price discrimination and predatory price signalling. Moreover, an incumbent firm's ability to limit or prevent arbitrage opportunities is a necessary condition for unreasonable price discrimination. The Commission should continue to vigorously apply its long standing rules against resale restrictions with respect to all forms of increased LEC pricing flexibility.

Finally, the Commission's overall pricing rules for downward pricing flexibility should provide incentives for LECs to self-select only efficiency-enhancing price reductions, screening out initially, as much as possible, overtly predatory actions through a ceiling price constraint. In a fully competitive market, firms do not realize "headroom" when they reduce the price of one retail product, and there is no reason to enable LECs to utilize "headroom" in order to fund costless price discrimination or predatory price

signalling in some markets. The effects of all changes in the actual price indexes for the group of services broadly available as pricing options for price cap LECs (including the "Track 2" services, APPs and temporary promotional pricing plans) should be subtracted simultaneously from the upper limit of price band index. Except in the case of temporary offerings, the ceiling price reduction should be both immediate and permanent. It should be recalculated periodically to account for demand growth in the flexibly priced services.

**CERTIFICATE OF SERVICE**

I hereby certify that the foregoing Comments of the Association for Local Telecommunications Services was served December 11, 1995, on the following persons by first-class mail or hand service, as indicated.



Louise M. Banzon

Chairman Reed E. Hundt
Federal Communications Commission
1919 M St., N.W.
Washington, D.C. 20554

Commissioner James H. Quello
Federal Communications Commission
1919 M St., N.W.
Washington, D.C. 20554

Commissioner Andrew C. Barrett
Federal Communications Commission
1919 M St., N.W.
Washington, D.C. 20554

Commissioner Rachelle B. Chong
Federal Communications Commission
1919 M St., N.W.
Washington, D.C. 20554

Commissioner Susan Ness
Federal Communications Commission
1919 M St., N.W.
Washington, D.C. 20554

Regina M. Keeney*
Chief, Common Carrier Bureau
Federal Communications Commission
Room 500
1919 M St., N.W.
Washington, D.C. 20554

Geraldine Matise*
Chief, Tariff Division
Federal Communications Commission
Room 5wi
1919 M St., N.W.
Washington, D.C. 20554

Industry Analysis Division*
Federal Communications Commission
Room 534
1919 M St., N.W.
Washington, D.C. 20554

ITS*
2100 M St., N.W.
Room 140
Washington, D.C. 20037

*Hand delivery