Issue 5b: *Should we place additional limits on the ability of a LEC that decreases prices pursuant to this flexibility to subsequently increase those prices in order to preclude the potential for anti-competitive pricing strategies?*

Issue 5c: *Are there any other pricing flexibilities which we should adopt to promote cost-based pricing? How would the proposal promote our objectives? Would added flexibilities cause competitive harm? What is the relationship between downward pricing flexibility and the varying cost, demand, and other characteristics of different geographic markets? Should additional pricing flexibilities be considered in this proceeding or in another context?*

The Commission proposes to eliminate the lower service band limits for all service categories in the traffic sensitive and trunking baskets. As the Commission says,

> because of the administrative burden and length of time it can take for below-band filings to be approved ... inefficient entry may be encouraged and new or existing LEC competitors have no incentive to price their services at cost. Instead, they will price their service just enough below the LEC price to attract customers. If the lower service band limit were eliminated, the LECs and their competitors will be able to engage in true competition and bring prices down toward cost immediately. (para. 83)

We do not object to this proposal, but it affords us little or no downward pricing flexibility that we do not already have. The price cap rules generally allow price reductions to be offset by price increases only in the same band or basket. This requirement prevents us from exercising the full degree of downward pricing flexibility (15% for density pricing zones) that the Commission has already concluded we should have.

In addition, the Commission's latest proposal comes with "strings" attached that are irrational and irreconcilable with price cap principles. In conjunction with the proposal to eliminate lower service band limits, the Commission also proposes "with respect to any service category or subcategory in which a LEC makes price reductions pursuant to the pricing

flexibilities in this *Second Notice*, that the LEC be subject to a one percent upper SBI limit" (para. 105).

We oppose the "one percent rule" for two reasons. First, the harm that it causes would far outweigh any benefit. A carrier would think long and hard before reducing the price for a service, if it knew that such a price reduction would subject it to even more stringent price controls. The "one percent rule" would thus explicitly penalize price reductions, which *undoubtedly* benefit consumers, in order to discourage predatory pricing, the danger of which is at best extremely *remote*. It would harm consumers to protect competitors. This is a marked departure from the policies that led the Commission to adopt price cap regulation.

Second, it discourages efficient pricing and would send the wrong signals to consumers. We expect that, *on average* and adjusted for inflation, price reductions to meet competition will be permanent. But in competitive markets, there are often valid, cost-based reasons to increase the price of a service by more than one percent a year. In highly competitive businesses with cost structures that resemble our own, such as the air transportation business, rapid, substantial price increases that respond to changes in supply or demand are commonplace, although on average, inflation-adjusted prices have fallen in the long term.

In the somewhat less competitive long distance business, AT&T and its major competitors have frequently increased rates by 5-10% in one fell swoop, and the Commission has shrugged it off as "not relevant" to whether AT&T has market power.[29] The inconsistency between the "one percent rule" the Commission proposes to apply to us, and what it has witnessed and sanctioned in the long distance market is glaring.

In our own business, we have seen cost increases of far more than 1% per year for obsolescent services with declining demand, such as telegraph, metallic, and analog video

[29] AT&T Non-Dominant Order, para. 84.

services, whose customers are migrating to more advanced services. In such circumstances, the "one percent rule" would at the very least discourage the replacement of old services and technologies by new ones. The proposed rule seems a classic example of how consumer welfare may be destroyed by price controls.[30]

Issue 6a: *Would any revisions to the price cap baskets serve our goals in this proceeding? If so, explain how they would serve those goals. Would there be any adverse effects on end-users or competition?*

Issue 6b: *Under what circumstances should the price cap baskets be revised? Can revisions be planned to take place automatically on achievement of particular milestones or must they be done on an individual basis or after a periodic review? If they can be planned to take place on achievement of particular milestones, what should those milestones be? Should any individual review of the basket structure be done as part of a rulemaking proceeding? Are there any other procedures that would be appropriate?*

Issue 6c: *As competition develops at different rates for different services within different geographic markets, should different basket structures be established for a particular LEC or within a particular study area or even within a smaller geographic area?*

Issue 7a: *Would any service category consolidations serve our goals in this proceeding? If so, explain how they would serve those goals. Would there be any adverse effects on end-users or competition?*

Issue 7b: *Under what circumstances can consolidation of service categories occur?'*

Issue 7c: *If service categories are combined, how should the relevant SBIs and the SBI upper and lower limits be adjusted?*

In Figure 1, we show our proposal for price cap basket and band revisions. The price cap structure in Phase 1 (depicted in Figure 1) should be implemented immediately. The second phase (Figure 2) should be implemented when the Commission finishes its restructure of

[30] Reality would actually be worse than this example, because the "one percent" rule would apply to a price cap formula, not to a price. Productivity reductions, which are applied across the board, combined with the 1% rule, could force the nominal price of the service *down* even as its unit costs are *increasing*.

the local transport rules in CC Docket No. 91-213 and its investigation of 800 database services in CC Docket No. 93-129.

The price cap reforms that we propose would group together services with similar levels of competition, moderate the rate of change to an efficient price structure, and still allow us a meaningful opportunity to recover our costs. We define efficient price structure as the kind found in fully competitive markets. Other industries that have successfully made the transition from full price regulation to full competition -- air transportation, for example -- offer highly instructive examples of such price structures. In contrast to twenty years ago, when prices were controlled and artificial boundaries were maintained between "charter" and "scheduled" airline service (compare "switched" and "special" access), the air transportation business today is characterized by ubiquitous discounting, prices that respond rapidly (within hours) to shifts in supply and demand, and far greater total output -- *i.e.,* more passengers carried; more cities served; more consumer welfare; more *social* welfare[31] -- than would ever have been possible in a price-controlled system.

A reformed price cap structure is not a panacea, nor is it appropriate in competitive markets. As the CPUC has already recognized, services subject to competition should be offerable under contract without price controls (except for a price floor of long-run incremental cost), without reducing our ability to change the prices of the tariffed services remaining under price caps.

The current price cap baskets and bands undoubtedly send distorted price signals to consumers. For example, though subject to considerable competition in dense urban and

[31] This is because the more price-sensitive customers -- those of limited means -- seek out the discounts. The grizzled traveler who sits next to you and laments the passing of the Golden Age of Air Transportation, when prices were fixed, the food was good, and airlines "competed" by advertising how attractive their flight attendants were, probably never paid for his own ticket.

suburban areas, switching is still geographically averaged over our entire study area. Yet, as the Commission notes in paragraph 24 of the *Second Notice,* switching and transport are substitutable. (The Commission nowhere explains the inconsistency of this observation with its streamlining proposal, which deems switching and transport to be entirely different markets.) Likewise, the trunking bands do not allow us to reflect in prices the nearly complete substitutability of transport services such as DS1 and DS3.

In their Report, Prof. Kahn and Dr. Tardiff testify to the high degree of cross-elasticity not only between transport services, which are rightly and universally regarded as highly cross-elastic, but between switched and special access services.

A. The Common Line or Public Policy Basket

In Phase 1 of our proposal, this basket would contain the carrier common line charge (CCLC), and the End User Common Line Charge (EUCL). In Phase 2, this basket (renamed the Public Policy basket) would also contain what is left of the switched transport interconnection charge after the Commission adopts permanent rules for restructuring local transport (see below, p. 20).

More flexibility in recovering loop costs will avoid providing an incentive for uneconomic bypass of our network by major customers. The CCLC, for example, provides an artificial incentive for switched access users to cross over to special access. Building new transport facilities where idle switching capacity exists is, from an economic perspective, clearly irrational -- but it is being encouraged by the current rules. As Chairman Hundt recently said,

> We need to fix the Carrier Common Line Charge. This part of access charges works to make high-volume users subsidize lower-volume users.... as competition hits the local exchange market the system cannot continue. The fact is that the CCLC tends to drive access charges way above cost....
>
> If we fix the CCLC, then obviously we need to take a hard look at the hard caps on the Subscriber Line Charge. These charges are the two sides of

> the coin paid for access. Internet customers pay a flat rate; isn't it time to rely more on flat rates in local loop pricing? We need to find ways to let the subscriber line charge caps approximate economically rational pricing for consumers and single line businesses....
>
> We should be concerned about price shocks rocking consumers. But, we shouldn't be concerned about nickel and dime differences on the local telephone bill at the expense of having rational pricing.[32]

We agree with Chairman Hundt that the CCLC is unsustainable in a competitive environment. But his observation is an understatement. Technology and competition -- even the mere threat of competitive entry -- have made the whole game of "shift the subsidy" impossible to sustain. LECs should therefore have an option: increasing the EUCL as they reduce or eliminate the CCLC; or bulk-billing the CCLC.

Our current multiline EUCL rate -- $4.61 -- reflects that even if all common line costs were recovered from end users in one geographically averaged EUCL paid by both business and residence customers, the effect on consumers would be minimal.[33] Indeed, the effect would be positive. It has been shown that during the 1980s, increasing line charges and decreasing toll charges did not merely balance one another out, but led to overall increases in consumer welfare.[34]

Prices in the Common Line basket should also be allowed to reflect the three zones now used for switched and special transport. This would permit a modest amount of geographic deaveraging. The evidence submitted in CC Docket No. 80-286 demonstrate the substantial cost differences in providing loop service to different customers and topographies.

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[32] Address of Reed Hundt, Chairman, FCC, to Fall Business Conference, Competitive Telecommunications Association, October 10, 1995.

[33] Pacific Bell's current rate for one party flat rate residential service is $11.25, among the lowest in the nation.

[34] See J. Hausman, T. Tardiff, and A. Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the U.S.," American Economic Review (1993).

The Public Policy basket should (in Phase 2) include the residual interconnection charge (IC) for switched transport. First, however, costs properly allocable to tandem switching should be removed from the IC, as should costs for COE port and tandem transport. The only costs remaining in the IC charge should be costs allocated pursuant to Parts 36 and 69 that are inconsistent with the way that traffic actually flows. We estimate that the rationalized revenue requirement for the interconnection charge would be only about $25-40M.

B. The Switching Basket

New entrants target the most lucrative market segments. Despite the recent changes in transport prices and structure, switched access remains excessively vulnerable to competition because one half of the switched access equation, the switching function, carries relatively high margins with geographically averaged prices.[35] The requirement that we price-average by charging the same rates for switching throughout our service area, in spite of geographical differences in costs and market conditions, is economically unjustifiable. As the Commission implicitly acknowledged when it created the interconnection charge for local transport, switching is a traditional -- and increasingly important -- source of contribution to total network costs. It is critical to all customers on our network that we maintain this source of contribution.

For reasons of both technology and cost, the cross-elasticity between switched access and special access has increased to the point where the "crossover" dictated by today's price controls is unrealistic. When the access charge rules were adopted in 1983, switching (though it was already nothing more than microprocessing) was still relatively expensive and therefore centralized. The network was a pyramidal hierarchy. That is no longer the case. "The

[35] See *Expanded Interconnection with Local Telephone Company Facilities*, 6 FCC Rcd 3259, 3261 (1991).

once centralized network is becoming decentralized. 'Terminals' -- dumb end points to the network -- are giving way to 'seminals' -- nodes that can process, switch, store, and retrieve information with a power that was once lodged exclusively in a few fortified centers, massive switches, and mainframe computers."[36]

PBXs -- an antiquated term that we use reluctantly, because it is more familiar than "a microprocessor with line-concentrating capability" -- have enjoyed the same vast, geometric increases in capability and reductions in price as other computer equipment. They compete directly with our switches just as PC's compete with mainframes. Like an end office switch, a PBX gathers end user traffic and, using transport from us or one of our competitors, sends it directly to an IXC. (The only difference is that typically a PBX gathers traffic from a single "large" customer, and the end office gathers traffic from more than one customer. But as the price of transport continues to fall, "large" becomes smaller than it used to be.) The capacity of fiber is limited only by the microprocessing capability of terminal electronics: hence, as Peter Huber famously concluded, the most efficient network topology is not a pyramid anymore, but a geodesic. Yet switching is geographically averaged and price-controlled in much the same manner as in 1983, when state-of-the-art PC's had 64K of RAM, and the only fiber we had was one experimental ring being constructed to serve the 1984 Olympics.

IXC 800 services such as Megacom, Prism, and UltraWATS, which are marketed to the millions of customers who now have PBXs, have taken rampant advantage of the uneconomic crossover between switched access and special access. Once linked to these 800 services, PBXs can operate as standalone switching hubs or as remote switching nodes on private networks consisting of many switches and lines. They greatly reduce the need for access lines

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[36] Michael K. Kellogg, John Thorne, and Peter W. Huber, *Federal Telecommunications Law* (Boston, 1992), p. 50.

because calls of multiple users are aggregated over one facility --- typically a hicap to an IXC switch. They allow the user to avoid the switched network and connect directly to an IXC for inbound *and* outbound WATS/800. Because it cannot offer 800 service with interLATA capability, Pacific Bell has already lost a substantial share of the business systems market segment. Pacific Bell's share of intraLATA 800 minutes from 800 service has fallen by half over just the last four years, from 52% to 24%, in spite of Pacific's aggressive 800 pricing and marketing efforts and overall growth in 800 minutes of use in excess of 15% a year. Today, 800 services in California represent almost 9 billion minutes of use, and Pacific Bell has a tiny 6% share.

Because switching prices are not geographically deaveraged and do not have the same degree of pricing flexibility as trunking services, the crossover between switched and special access continues to decrease (*i.e.,* fewer minutes per month are needed to "prove in" a direct DS1 connection), exacerbating the imbalance in pricing flexibility between the switched access and trunking baskets. The price of transport is constant per month, with virtually unlimited usage, while switched access is priced based on minutes of use. The crossover is easily calculated. IXCs serving end users who make about 150 hours of toll calls per month (about 5-6 hours per day) would pay less by connecting to them directly with DS1 access instead of using the switched network.[37] We need the price structure for switching to match the price structure for transport, with zone pricing, volume and term discounts, and contract based pricing.

In both Phase 1 and Phase 2, there should be two service categories in the Switched Access basket. The first category, Switching, will initially consist of local switching

[37] Our $124 channel termination rate, plus $46 for a pro rata share of DS3X3 entrance facility, equals $170 -- the access cost incurred for a typical circuit of 0 miles. With an average switched rate of $.019 per minute of use (weighted by jurisdiction), the crossover point between switched and special access is therefore 8,950 minutes per month, or about 150 hours per month.

elements. In Phase 2, after local transport has been rationalized, this category will also include tandem switching. The second service category in the Switched Access basket, Other/Features, will contain all of the switching rate elements except for those in the Switching category: information, BNA, and busy line verify and interrupt (currently in the interexchange basket). In Phase 1, there will also be a Database sub-category containing the 800 database element and the 800 vertical features. After Docket 93-129 concluded, the Database sub-category will be eliminated, and the rate elements incorporate directly into the Other/Feature category.

In Phase 2, the Directory Assistance and Operator Services rate elements specified in Part 61, Section 61.42(e)(1)(ii) and currently in the Information service band should be removed from price caps because they are fully competitive. See below, pp. 31-32.

To reflect its substitutability with trunking, switched access charges should be de-averaged in the same manner as transport charges. The zones currently used for transport should be used for switching, since switching enjoys economies of density very similar to trunking. In addition, switched access traffic was considered when these zones were developed.[38]

In Phase 2, Tandem switching charges should be in the same category (Switching) as other local switching charges. Tandem switching and end office switching are technologically indistinguishable, and functionally overlapping. "Tandem" switches long predated equal access. Many dialtone switches aggregate traffic, as equal access tandems do, while some of our equal access tandems are actually dialtone-providing offices. Tandem switching is subject to competitive pressure from our own local switching, transport and collocation services, as well as a flora of competing switches and networks. In CC Docket 91-141, the Commission recognized

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[38] See *In the Matter of Expanded Interconnection with Local Telephone Companies,* 7 FCC Rcd 7369, para. 179, n. 415: "In classifying central offices, we require the LECs to consider factors such as the density of total interstate traffic which should reflect cost patterns more accurately

the existence of competing tandem switching providers, or "TSPs." The Commission contemplated that TSPs:

> would use either their own collocated facilities or LEC facilities to carry traffic from the LEC end office to their own tandems. We also contemplated that if a TSP sought interconnection at the LEC tandem, rather than the end office, the LEC would provide tandem-switched transport for the originating traffic from its end office to its tandem. From there, either the interconnector (if collocated) or the LEC (if the TSP were not collocated) would transport the traffic to the TSP tandem. In either case, the TSP would switch the traffic at its tandem and transport it to the appropriate IXC over its own direct-routed facilities.[39]

As one TSP -- the Minnesota Independent Equal Access Corporation (MIEAC) -- has pointed out in its brief in the appeal of the interim local transport rules, the current price controls on tandem switching artificially deter competitive entry.[40] Hence the Commission's policy on competitive tandem switching is inconsistent. On the one hand, the Commission seeks to encourage competition for tandem switching by requiring LECs to provide signalling information and tandem collocation to TSPs; on the other hand, it discourages such competition by artificially depressing the price of LEC tandem switching.

Nonetheless, as MIEAC proves, TSPs do exist and already provide tandem switching. A major competitive access provider in our area provides dedicated facilities between its switch and IXC POPs for both originating and terminating traffic, which it gathers from, and delivers to, Pacific Bell's end users using collocation at access tandems, end offices, or any other combination of switches. As price controls on tandem switching are lifted, we expect more competitors to do the same, because it is a logical product line extension for them.

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[39] *Expanded Interconnection with Local Telephone Company Facilities,* 9 FCC Rcd 2718, para. 8 (1994).

[40] See Brief of Intervenor Minnesota Independent Equal Access Corporation, Inc., Competitive Telecommunications Ass'n, et al., v. FCC (D.C. Cir. Nos. 95-1168, 95-1170), filed Nov. 17, 1995.

C. The Transport Basket

In Phase 1 the Transport basket should be divided into four categories.

Analog and Digital services should comprise two of the categories. Analog would include all elements currently in 47 CFR Section 61.42(e)(2)(i) and (ii). Digital would include all elements currently in 61.42(e)(2)(iii). The upper and lower SBI limits for the Digital service category will remain the same as today -- 5% upward and 15% downward.

The third category in the Transport basket (in Phase 1) should be Tandem transport. Tandem transport would include all of the services currently in Section 61.(e)(2)(v). In Phase 2, when the Commission's transport restructure rulemaking is concluded, this category would be eliminated. All of the tandem switching rate elements would be moved to the Switching service band in the Switched Access basket, placing all switching rate elements in the same basket.

The fourth category in the Transport basket (in Phase 1) should be the IC. The IC category would be eliminated in Phase 2 when the costs reflected in this charge have been reassigned to the rate elements in other service bands and into the Public Policy and Switched Access baskets.

Beginning in Phase 1, an end office trunkside port charge would apply to all traffic switched at one of our end offices. The interconnection charge would be reduced accordingly.

D. Reweighting of Price Cap Service Categories

Service categories should be combined in an annual filing, with the new SBI set at 100, and the full upward and downward pricing flexibility allowed after the percentage change in the PCI. This avoids the cumbersome process of weighting the prior SBIs for the new range of rate elements. If reinitialization occurs other than during an annual filing, a weighted average

SBI would need to be calculated to reflect the relationship of the SBIs to their upper and lower bounds as was determined in the prior annual filing.

Issue 8: *Should operator services be placed in its own service category in the traffic sensitive basket or combined with another new or pre-existing service category?*

Issue 9a: *What is the proper price cap treatment of operator-related call completion services?*

Operator services are fully competitive. Nothing prevents end users (with one exception -- inmates, whom operator service providers compete vigorously to serve) from reaching the operators of their choice. For years IXCs have been educating consumers to dial 10XXX plus "0" to reach their operators. More recently, they have spent millions teaching customers to dial 1-800-OPERATOR, 1-800-COLLECT, or 1-800-CALLATT. Phone debit cards also bypass LEC operators. These prepaid cards have instructions for dialing the issuer of the card rather than the LEC operator.

Call aggregators, such as payphone operators and hotels, also contract with operator services providers other than the LECs. Prison payphones, which once provided a large portion of operator services revenues for LECs, have been targeted by the IXCs as a new source of revenue. An MCI senior vice president estimates that his company has increased its share of inmates' long distance calls form 10 to 30 percent in the last three years.[41]

For years we have competed with GTE to provide directory assistance (DA) to IXCs. For years we have also sold direct access to directory assistance to IXCs and major businesses. Now, however, anyone can go to a computer software store and buy directory listings. A recent Egghead Software advertisement offered 70 million names, addresses, and

[41] Alix M. Freeman, "'Mom, It's Mugsy': Phone Firms Wrestle for Prisoner's Business in Hot Growth Market," Wall St. J., Feb. 15, 1995, p. A1.

phone numbers on a CD ROM for only $19.98. Marketing firms and other businesses that previously used operators to obtain listings can now buy their own CD ROM directories.

There are also many DA providers who are not LECs and do not use CD ROM. These providers (such as AnswerSoft Inc., NDA Teleservices, and INFONXX Inc.) compile listings and provide directory assistance to IXCs, cellular providers, and others.

Operator services know no geographical bounds. They may be provided from any location in the world, to any other. They should be removed from price cap regulation throughout our serving area.

Issue 9b: *What is the proper cap treatment of directory assistance-related call completion services?*

When we offer these services, we would propose to exclude them from price cap regulation.

Issue 10a: *As to each proposed relaxation of regulation and pricing flexibility, should LECs be permitted to take advantage of the regulatory relief and pricing flexibility at this time or should they first have to make a showing that a certain level of completion exists before being able to use it? If a showing should be required, what should the showing be and why?*

No showing should be required. The price cap reforms that we propose may be justified entirely on the basis of more closely aligning rates with costs and market conditions -- one of the fundamental principles of price cap regulation.[42] Indeed, when the Commission first proposed price cap regulation for the LECs in 1988, there was far less competition than today. But the Commission proposed just two baskets, and no bands.[43]

Issue 10b: *What is the relationship between the various regulatory relief and pricing flexibilities we have proposed and should any restrictions be placed on the ability of a LEC to take advantage of one type of relief or flexibility in*

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[42] See above, n.2.

[43] *Policy and Rules Concerning Rates for Dominant Carriers,* 4 FCC Rcd 2873 (1989).

combination with another? Should some relief be granted only after successful implementation of other forms of relief, or are there other sequencing concerns we should consider?

Our proposal for price cap reform has two phases. The timing of the second phase will be determined by the Commission's deliberations in CC Docket No. 91-213 and the 800 database investigation. No other phasing is required.

Issue 10c: *Should we impose new limits on subsequent upward pricing flexibility after a price has been reduced? If so, what should those limits be? If such limits are unnecessary, explain why they are not needed to protect consumers and to insure a competitive marketplace.*

No. The Commission has determined that the current limits on upward pricing flexibility adequately protect consumers and promote competition.[44] It would be irrational to find that greater downward pricing flexibility, which would result in prices that are closer to competitive levels, would make existing limits on upward flexibility inadequate. Any reduction in the current upward limits would boil down to a political quid-pro-quo -- an unreasoned penalty for moving our prices toward economic costs.

Issue 11a: *Which of the changes discussed in Section IV.B. herein, if any, should be predicated on a demonstration that certain barriers to entry have been removed, and why? If such a demonstration should be required, should a competitive checklist be used and, if so, what should be included in it? Are there any other tests for the existence of competition that should be used to determine whether regulatory relief and pricing flexibility should be granted? Should any of the proposed changes to our price cap rules be predicated on a demonstration of actual competition or upon some other circumstances and, if so, why?*

If it linked price cap reforms to removal of "entry barriers" -- in particular, alleged entry barriers to the *local exchange* market, not the *access* market -- the Commission would merely be exacting a political fee for reforms it should be enacting anyway. Reforming price cap

[44] See above, n.2.

rules to permit more rates to reach competitive levels is justified on its own merits. Price caps was meant to "mirror the efficiency incentives found in competitive markets,"[45] not to be an overlay on them. The Commission spoke with disapproval of "applying incentive regulation to a carrier or industry that faces substantial competition."[46] Price cap regulation was never intended to coexist with competition. In competitive markets, the rationale for price cap regulation vanishes. If there are no barriers to entering the access market, it can only justify *eliminating* price cap regulation, not improving it.

In addition, any "barriers to entry" checklist would fail to consider the considerable competition that already exists. Indeed, as Prof. Daniel F. Spulber demonstrated in a recent article, the competitive entry that has already occurred moots the whole issue of entry barriers. Spulber points out there are two main types of barriers to entry: sunk costs and government regulation.[47] Neither type of barrier, Spulber shows, exists in local telecommunications markets. Among other reasons, "the argument that sunk costs constitute a substantial barrier to entry into the local exchange is also rendered invalid by *the substantial entry into local telecommunications that has already occurred* ... by long-distance companies, dozens of competitive access providers, cable companies, cellular companies, and other wireless transmission suppliers.... After their irreversible investments have been made, entrants become incumbents. From that point forward, the costs of entry cannot be used to distinguish RBOCs from new communications providers."[48]

Government regulation also is no longer a barrier to entry in the local exchange. Instead, it is a burden that we alone bear. Competition for every telecommunications service will

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[45] LEC Price Cap Order, para. 33.
[46] *Id.*
[47] Daniel F. Spulber, "Deregulating Telecommunications," *Yale Journal on Regulation,* vol. 12, no. 25 (1995).
[48] *Id.*, pp. 49-50.

be legal in California in 1996. We will be required to resell dialtone to competitors by March 1, 1996. We have reached an historic agreement to sell unbundled links to MFS beginning on April 1, 1996 (and we will offer links on the same terms to any other provider). California state law requires the California Public Utilities Commission to certify that the loop has been unbundled *before* Pacific may enter the interLATA market.[49] Collocation and compensation arrangements have already been provided for. Rules for number portability and resale of unbundled loops will be issued soon. The CPUC is currently processing sixty-six applications for local operating authority. There *are* legal barriers to entry in the telecommunications business -- but they protect only our competitors in the long-distance telephone and cable industries.

Today, everything in the local exchange may feasibly be duplicated. Indeed, to name only one example of duplication, cellular networks in every one of our exchanges already have made our switches and wires redundant. They are full-service providers, integrating local, interLATA, and enhanced services; we are not allowed to be. Because it offers mobility and one-stop shopping, cellular service commands a premium price, and attracts the most affluent customers. Cellular service is the keystone of AT&T's strategy to skim the profit in the local exchange. AT&T now has offered to send some customers cellular pocketphones for a dollar, and through its "True Reach" promotion combines discounts on long-distance and cellular calling.[50]

Recently, the Commission has proposed to waive rate regulation for Dover Township, New Jersey because, even though it found "the penetration rate of VDT programmers will not reach a mature level immediately ... the *commencement* of VDT service by Bell Atlantic *may restrain prices* and prompt other competitive responses from cable operators such that

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[49] Cal. Pub. Util. Code, Sections 709.2(c)(1), (2), (3), (4) (emphasis added).
[50] See "AT&T Eagerly Plots," p. A1.

application of our CPST rate rules will be unnecessary."[51] Nothing less is called for here. When two or more facilities-based providers serve a market, price regulation of that market is unnecessary.

Issue 11b: *In addition to adopting a "competitive checklist", are there other steps that need to be taken to ensure competition in the interstate access market. For example, is it necessary for the LECs to separate local bottleneck facilities, such as loops and switching, through a separate subsidiary, and to provide these facilities to all access providers at "wholesale prices"?*

There would be no justification for requiring "separate local bottleneck facilities, such as loops and switching, [to be offered] through a separate subsidiary, and to provide these facilities to all access providers at 'wholesale prices.'"

First, the question assumes a bottleneck. Yet none exists. See above, p. 35. When our loops are unbundled on April 1, 1996, end user customers need not come to us for either loops or switching. The first competitor to buy unbundled loops, MFS, will control the customer, and may transport all traffic to its own switch thanks to collocation. Even in the absence of unbundling, the Commission's characterization of switching as a "bottleneck" is still astonishing, given its earlier admission that switching and special access are substitutable (para. 24), and given news reports that AT&T has installed 880 communications "nodes" (the equivalent of Class 5 switches) nationwide, subtending 72 larger "tandem" switches.[52]

The second prong of the "bottleneck facilities" test -- the ability to impede competition in the downstream market -- does not apply either. This is no surprise. No one has

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[51] *Waiver of the Commission's Rules Regarding Rates for Cable Services,* FCC 95-455, Order Requesting Comments, CUID Nos. NJ0213, NJ0160 (released November 6, 1995).

[52] "AT&T Eagerly Plots," p. A1. See also John J. Keller, "AT&T Vows Battle to Offer Local Service," Wall St. J., Oct. 27, 1995, p. A3, in which AT&T Chairman Robert Allen was quoted as saying, "We will fight for the right to give our customers a choice for local service through every option open to us. That includes reselling local services, using alternative providers and building our own telephone-network facilities."

ever described a lawful or even plausible mechanism that would enable BOCs to leverage their access facilities (even if they were "essential") into other markets. The Commission's question suggests a certain degree of amnesia. Access services are tariffed and price-controlled. The Commission would have to overrule dozens of its own decisions before it could find that its regulation of our access services is insufficient, so that another divestiture is required. Under our proposal, access services would continue to be available under tariff, even in competitive areas where they would also be available under contract.

Issue 12: *What is the best procedural mechanism for price cap LECs to use when seeking regulatory relief or pricing flexibility within the price cap plan?*

For reasons we stated above, we oppose meeting any checklist as a condition of beginning the process of price cap reform. However, if a checklist is used, the process must be objective and self-executing, not a matter for prolonged adjudication. It should be based on competitive alternatives in the access market, such as the number of offices tariffed for collocation, not a theory of "entry barriers" to the exchange market. Some, though not all items on the NYNEX checklist pass this test.

Issue 13: *Should we use the existing price cap service categories within the baskets to define the relevant product market?*

No. Contrary to what the Commission says, these service categories were not developed after considering cross-elasticities. They were developed to slow down price changes and to protect our competitors.[53]

Issue 14a: *Should the Commission adopt density-based pricing zones as the relevant geographic market for assessing competition and granting regulatory relief under price caps? Should some other defined geographic area be used?*

[53] See LEC Price Cap Order, para. 223.

Issue 14b: *If we condition the regulatory relief and pricing flexibility discussed in Section IV.B. on a demonstration of competitive conditions, should the relief and flexibility be allowed only in the geographic market in which the demonstration of competitive conditions has been made? How would this affect interstate toll rates? Should the relief and flexibility be permitted in an entire study area even if a demonstration of competitive conditions has been made only in a portion of the study area?*

What the Commission suggests by this question is, in effect, two overlapping price cap systems, one operational in more competitive areas, one in less. Presumably, the boundaries between the two would shift constantly. These overlapping price cap regimes would be in addition to the other two "gradations" the Commission has proposed. Such a system could be an administrative nightmare. Even if the costs and revenues of the two systems did not have to be separately identified and monitored (as they would have to be for any LEC that shares revenues), the constant re-initialization of price caps and indices in *two* price cap models would make cost-of-service regulation look comparatively simple.

III. Streamlined Regulation

The Commission's proposal for streamlining regulation takes a step in the right direction, but has three major flaws.

First, the "relevant markets" proposed by the Commission -- that is, *what* services will be "streamlined" and *where* -- are too confining. The Commission proposes to treat the price cap service bands and sub-bands as economically relevant markets within specific geographical areas. But the service bands were never set up for that purpose and, as we show elsewhere in these Comments, the bands (as well as baskets) fail to reflect cross-elasticities between services.

Second, under the Commission's proposal, the removal of these "markets" would reduce the amount of upward pricing flexibility -- hence, reduce the ability to recover costs -- that we would have if they remained under price cap regulation. That price reforms necessitated

by the Commission's own policies (such as the promotion of competition in access markets) should make it impossible for us to recover our full cost of service is irrational, anticompetitive, and hard to square with *Hope, Duquesne,* and other cases on confiscatory regulation. It is also inconsistent with the Commission's regulatory treatment of AT&T. AT&T, for example, was allowed to take "credit" in its price cap indices for price reductions intended to meet competition, and the Commission explicitly approved of the resulting price increases.[54] This was consistent with the Commission's orders allowing zone pricing. The Commission said:

> We believe that the customer interest in increased access competition requires the Commission to give the LECs flexibility to price their special access services closer to cost in the manner we propose. Failure to change the current system of uneconomic rate averaging would seriously constrain access competition and potentially deprive customers of the attendant benefits. The safeguards that we are adopting will limit the magnitude of the rate differentials [between zones] and introduce them gradually to avoid harming customers in higher cost areas.[55]

Finally, the proposed criteria for streamlining are too subjective and would create impracticable burdens for the Commission and for LECs. The Commission reclassified AT&T as a nondominant carrier based on just one showing. But the Commission proposes to streamline our business by examining each service in each geographic area. This would require the LECs to file hundreds of showings, each as complex as an antitrust case.

Below we provide answers to the Commission's questions (once again in italics), and present our own proposal for streamlined regulation.

Issue 15a: *Should demand-responsiveness be a factor in determining the level of competition for purposes of determining whether services should be streamlined? What should be the relevant factors in determining whether a LEC's customers are demand-responsive? What data and information would be necessary and relevant in determining whether a LEC's customers are demand-responsive? Does the fact that LECs have relatively few customers that account for most of their interstate access*

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[54] See AT&T Non-Dominant Order, para. 84.

[55] 7 FCC Rcd 7369, para. 184.

demand affect the usefulness of demand-responsiveness as a factor in determining the level of competition?

Issue 15b: *Should supply-responsiveness be a factor in determining the level of competition for purposes of determining whether services should be streamlined? What should be the relevant factors in determining whether a LEC's competitors have enough readily available suppl y capacity to constrain the LEC's market behavior and inhibit it from charging excess rates? What data and information would be necessary and relevant in determining whether a LEC's competitors are supply-responsive?*

Issue 15c: *Should market share be a factor in determining the level of competition for purposes of determining whether services should be streamlined? If the Commission considers the relative market share of the LECs and their competitors as one factor in assessing the level of competition for LEC services, what data and information would be necessary to assess the relative market shares of the LECs and their competitors? What should be the relative importance of the market share of the LECs and their competitors in light of other factors incorporated into our analysis and on any other factors that may be proposed?*

Issue 15d: *Should we consider evidence that a price cap LEC is pricing services below the price cap ceiling over a sustained period of time as additional evidence that such services are subject to competitive pressures in markets with high supply and demand elasticities? If so, what is the competitive significance of a LEC's pricing below the price cap ceiling for such a period?*

Issue 15e: *Should the Commission consider factors other than demand responsiveness, supply responsiveness, market share, and pricing behavior in assessing the level of competition for LEC services? If the Commission considers such other factors in assessing the level of competition for LEC services, what data and information would be necessary to assess the relative importance of these factors?*

Issue 16a: *Should the Commission allow the price cap LECs to offer individually negotiated contracts for services subject to streamlined regulation, provided such contracts are made generally available to similarly situated customers under substantially similar circumstances? In particular, would allowing such contract carriage benefit consumer welfare, foster competition, and foster efficient use of the network? Would allowing such contract carriage result in unreasonable price discrimination?*

Issue 16b: *If such contracts should be allowed, what tariff filings requirements should we adopt for such rates? Specifically, should we require the LECs to file on 14 days' notice a tariff summarizing the contract and containing the following information: (1) the term of the contract, including any renewal options: (2) a brief description of each of the services provided*

under the contract; (3) minimum volume commitments for each service; (4) the contract price for each service or services at the volume levels committed to by the customers; (5) a general description of any volume discounts built into the contract rate structure; and (6) a general description of other classifications, practices, and regulations affecting the contract rate?

Issue 17: *What procedure should be followed to implement streamlined regulation for a LEC?*

It is real progress to conclude, as the Commission has, that a consideration of market power is based primarily on supply and demand elasticities. But statements of principle do not always make for workable rules. Because the Commission takes no position on how *much* elasticity would justify how *much* relaxed regulation, under its streamlining proposal the Commission would have to adjudicate the equivalent of a complex antitrust case in every competitive area -- for *every service*. The potential expense and delay of this approach cannot be overstated. It invites a litigation train wreck.

Precise data on supply and demand elasticities in local telecommunications markets is hard to come by. Our own data will be of little or no use to the Commission in determining how much market power we have; our *competitors'* data is what counts. What we have on our competitors is the proverbial tip of the iceberg -- the rest is proprietary. The Commission could order our competitors to supply data, such as maps of their principal transmission lines and switching capacity, but our competitors would likely seek confidential treatment of this data, and a FOIA proceeding would have to be concluded before anything could be done with it. (We note that in its proposed Telecommunications Access Provider Survey, the Commission requires the filing of neither maps, nor switching capacity, nor the serving areas of switches.[56]) The FOIA proceeding over the cost support data for ONA BSEs took two and half

[56] See Public Notice, "The Common Carrier Bureau Seeks Comment on Telecommunications Access Provider Survey," DA 95-2287, released Nov. 3, 1995.

years to conclude, from Allnet's FOIA request to its seemingly final disposition by the Court of Appeals.[57]

Because user demands are so highly concentrated in telecommunications services, even knowing the full extent of our competitors' networks would not indicate the true degree of competitive pressure on our services. One of the most important forms of competition is self-supply or contract carriage by large, intensive users, providing direct connections to IXCs using satellite, optical fiber, or microwave, and self-supplying their own services.

Our plan for streamlining would permit contract carriage of all services in specific, limited competitive geographical areas, based on objective criteria. All of the services in a wire center should be eligible for contract-based pricing when we show that a competitor has built a network in the wire center serving area. Examples of competing networks that would create eligibility for contract-based pricing in a geographic area are shown in Attachment 2.

The actual number of geographic areas where contract carriage would be justified is small. In the near future Pacific anticipates no more than five to eight competitive showings, comprising about forty wire centers. But it is extremely important that in this small number of areas, we be permitted to compete. Our demand is not homogeneous. For a new entrant to compete away ten percent of our business, they do not have to compete away ten percent of our customers.

The distribution of revenues for telecommunications service is highly concentrated: a small percentage of customers, lines, and geographic areas accounts for a very large share of the revenues in most service categories. 70% of Pacific Bell's access lines are located in the two major metropolitan areas of Los Angeles and San Francisco, and 85% of our

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[57] *Allnet v. FCC,* 800 F.Supp. 984 (D.D.C., 1992); Allnet v. FCC, D.C. Cir. No. 92-5351, Memorandum Judgment, May 27, 1994.

toll revenues are located in just 6% of California's land mass. Pacific's top 62 wire centers, or 10% of the state's total, account for 40% of total revenues. The top 20% of wire centers account for 63% of total revenue. The bottom 50% of wire centers generate less than 7% of revenues. We have tariffed 86 wire centers for collocation at the request of our competitors. These 86 tariffed offices (12 percent of Pacific's wire centers) account for 45 percent of total switched access minutes, 74 percent of DS1s, and 88 percent of DS3s.

The rational entrant will target its initial entry at the small share of customers who account for this large share of revenues. MCI has already announced that it will begin with the business market and then focus on the residential market.[58] Moreover, because we are not allowed to de-average most of our prices to reflect their actual costs, profitability is even more concentrated than revenues, with the highest volume customers in the lowest-cost areas.

Our competitors have plenty of switching capacity in these areas to constrain us. AT&T has installed 880 communications "nodes" (the equivalent of Class 5 switches) nationwide, an average of five for each LATA, subtending 72 larger "tandem" switches.[59] It will serve the crown jewel of our wire centers -- SF01 -- and the rest of California with multiple 5ESS switches. TCG and MFS have ATM switches in San Francisco; Brooks plans to install one in San Francisco in mid-1996; Intelcom Group (ICG) has one in Oakland. Similarly, the California Cable Television Association has said that its members will invest $8 billion in the next two to three years to expand telephone networks in California, and that they will provide up to 70% of Californians with competitive local service sometime in 1997.[60] ALTS, just one of our competitors' trade associations, has said that its members have 500 networks operational or

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[58] "MCI Widens Local Effort," *New York Times*, December 12, 1995, p. C5.
[59] See above, n. 52.
[60] "Pac. Bell To Seek Compensation," Dow Jones/News Retrieval COMPANY NEWS, July 24, 1995.