

2. Separate Tracks for New Services Are Not Required.

TRA, Ad Hoc, MCI and Time Warner all suggest that new services receive Track 1 treatment.³³ Such a proposal is unnecessary and self-serving. New services represent new options for customers. Customers will (and should) make the decision as to whether the new service is a viable offering. Customers cannot be harmed by a new service offering. Therefore, restrictions on exchange carrier new service offerings are unnecessary and can only benefit their competitors who are not subject to such restrictions. Competitors are offering new services. It is in their best self-interest to prevent exchange carriers from offering new services under the same circumstances they do. Again, the tariff review process will permit sufficient oversight. Certainly AT&T received flexibility in its new service offerings long before the Commission determined that effective competition existed in the interexchange market. All new service should be treated in the same manner as the Commission proposes to treat Track 2 services.

3. A Fourteen Day Notice Period is All That is Required for Restructured Services.

There were few objections to the Commission's proposals regarding restructured services.³⁴ Therefore, there is no need to maintain the current 45 day notice period for these types of services. The Commission has the authority to defer action and review such proposals. Nothing has been proposed which would interfere with that authority. Since there is sufficient

³³Time Warner at p. 11, TRA at p. 26, MCI at p. 10, and Ad Hoc at p. 7.

³⁴Several parties, Time Warner at p. 15, NCTA at p. 22 and TRA at p. 27, seem to be confusing the Commission's proposal to shorten the time for price cap review with Commission review of Part 69 changes.

opportunity for review, the Commission should eliminate the 45 day notice period. USTA suggests a uniform fourteen day notice period.

4. Exchange Carriers Should Be Permitted to Offer Alternative Pricing Plans (APPs).

As USTA pointed out in its comments, APPs, including term and volume discounts, should be permitted as these types of offerings improve the efficiency of access pricing, encourage the development of new service options for customers and promote competition by allowing exchange carriers to respond quickly to market demands. Several commenters suggest that APPs be subject to such extensive restrictions that exchange carriers would have no incentive to offer them.³⁵ These restrictions are not necessary. APPs are a prevalent feature of both regulated and unregulated markets. Competitors already provide such offerings such that they are widely available in the telecommunications market today for virtually every service except switched access. By allowing exchange carriers to offer APPs that reflect rates that are closer to costs for switched access service, the Commission will facilitate economic pricing and customers will reap the benefits. This will not impede competition.

When the Commission opened its proceeding to determine the appropriate guidelines for allowing AT&T to offer optional calling plans, it did not even consider competition in the interexchange market. “In this docket we do not address the issue of whether AT&T continues to have substantial market power but assume *arguendo* that it does have sufficient dominance to

³⁵MFS at p. 2, AT&T at p. 28, CompTel at p. 28, Sprint at p. 18, Time Warner at p. 15 and Ad Hoc at p. 14.

justify regulatory scrutiny of its MTS offerings.”³⁶ The Commission assumed that AT&T had market power, but ultimately granted relief anyway. This is because the Commission believed that the optional calling plans would allow “AT&T to price its services in a way that reflects the true economic costs of providing service,”³⁷ and would “provide consumers with some of the benefits of competition as the telecommunications market continues to mature.”³⁸ As discussed above, sufficient protection exists to guard against anticompetitive behavior.

The Commission has recognized that APPs, including discounts, represent normal marketplace behavior. The benefits of these offerings flow directly to customers in the form of increased services and lower prices. The Commission should permit exchange carriers to provide APPs without unnecessary restrictions to maximize the benefits to be realized.

B. The Pricing Flexibility Recommended by USTA Will Facilitate Economic Efficiency.

Dr. Hausman explains the necessity of adopting greater pricing flexibility in baseline regulation. “Regulation often leads to large distortions in prices. Technology changes so that the cost of providing a regulated telecommunications service decreases markedly. Nevertheless, regulators continue to set a price (rate) which increasingly exceeds cost in order to subsidize other services to meet political or other social objectives. Economic efficiency is decreased

³⁶Guidelines for Dominant Carriers’ MTS Rates and Rate Structure Plans, CC Docket No. 84-1235, Notice of Proposed Rulemaking, released January 14, 1985 at ¶ 1.

³⁷Id. at ¶ 4.

³⁸Guidelines for Dominant Carriers’ MTS Rates and Rate Structure Plans, CC Docket No. 84-1235, Memorandum Opinion and Order, released October 17, 1985 at ¶ 3.

when prices are not related to costs in an economic manner...Thus the ability of a LEC to lower its prices, increase demand, and offer new services at economic price levels leads to large gains in economic efficiency.”³⁹ As GSA explains in its comments, “increased pricing flexibility has a dual advantage. It allows carriers to set prices closer to the corresponding levels of cost, and it provides ratepayers with greater options in the manner in which they buy services.”⁴⁰

1. Exchange Carriers Should Be Permitted to Offer Contract-Based Pricing.

Contract-based pricing is a normal business practice in the telecommunications industry for all except exchange carriers. Allowing exchange carriers to participate without unnecessary restrictions,⁴¹ again, will translate into direct customer benefits. Exchange carrier competitors can simply price their services at a lower rate than the exchange carrier’s tariffed rate. As a result, customers do not receive competitive rates. Exchange carrier participation would rectify that problem and ensure that contract-based offerings better reflect the costs of the services offered.

There is no downside risk to granting exchange carriers this kind of flexibility. As GSA notes, “there seems to be little relevance, and certainly no benefit from imposing any time limit on ICB arrangements. The unique system architecture of an ICB arrangement of multiple access services is not something that expires with age. Nor is it likely to grow more “like” other system

³⁹Dr. Hausman at p. 4.

⁴⁰GSA at p. 5.

⁴¹NCTA at p. 25, Time Warner at p. 17 and MCI at p. 14.

configurations over time.”⁴² Since contract-offerings are not under price caps, there would be no opportunity to create headroom. These offerings are by definition competitive, so there is no threat of unreasonable discrimination. In fact, the states have allowed forms of contract pricing for many years. In Georgia, Louisiana, and Mississippi, contract-based service arrangements are permitted without any restrictions. Other states permit such arrangements with some restrictions. For example, Florida limits contracts to certain services. In Illinois, only competitive services may be offered either as a customer specific contract or as a competitive tariff. North Carolina and South Carolina require contract offerings to be tariffed and cost support to be supplied.⁴³

Again, the Commission permitted AT&T to offer contract pricing for large business and government customers long before it found effective competition in the interexchange market. AT&T’s Tariff 12 was first filed in 1987. It provides tailored options for particular Fortune 500 customers. More than 200 such contracts have been filed to date. Tariff 16 permits AT&T to supply reduced-price service to state and federal governments and agencies.⁴⁴ The Commission should adopt USTA’s proposal to permit exchange carriers to respond to requests for proposals in baseline regulation and should not impose the unreasonable restrictions proposed for individual case basis tariffs.

⁴²GSA at pp. 10-11.

⁴³Other states that permit contract-based offerings include Alabama, California, Delaware, Kentucky, Maryland, New Jersey, Pennsylvania, Tennessee, Virginia, West Virginia and the District of Columbia.

⁴⁴Schmalensee and Taylor at pp. 6-7.

2. The Lower Band Limit Should Be Eliminated.

Dr. Hausman observes that “[i]t is a fundamental economic principle that consumers benefit from lower prices...Consumers will benefit and economic efficiency will increase if LECs choose to lower prices, regardless of the level of competition in access or local exchange markets...Thus, the current ‘lower bands’ contained in the price cap regulation should be eliminated to permit unlimited downward pricing flexibility. Nor should any subsequent restriction be placed on the LECs’ ability to subsequently raise their prices so long as they stay within the upper pricing limits.”⁴⁵ As GSA noted, the effect of such constraints would be to discourage lower prices.⁴⁶ USTA strongly disagrees with those parties that would place these types of unnecessary restraints on pricing.⁴⁷

AT&T supports the Commission’s proposal to eliminate lower SBI limits only if what AT&T considers to be sufficient safeguards against cross subsidization are put into place. AT&T’s suggestion that the Commission require exchange carriers to exclude price reductions beyond the existing lower band limits from the API calculation and impose a one percent upper band limit for categories with price reductions below the former SBI band limit should be rejected for the following reasons.

First, AT&T mischaracterizes cross subsidization. Cross subsidies occur when revenues acquired from one service are used to make up a revenue shortfall in another service, one that is

⁴⁵Dr. Hausman at p. 4.

⁴⁶GSA at p. 7.

⁴⁷AT&T at Appendix B, At Hoc at p. 18, and Sprint at p. 20-21.

priced below incremental cost. AT&T's assumption that a price reduction in one service means a price increase in another service is incorrect. Second, AT&T's proposal assumes that in all cases, economic cost will be reached by lowering prices. This, of course, is not always true. Ironically, implementation of AT&T's proposals would mean that any services with rates that are below costs or with rates that no longer recover a reasonable amount of common costs (e.g., services utilizing outdated technology) could not be raised to economic cost, since the one percent limit and the lack of an API credit for other reductions would prevent realization of economic cost. It is possible that AT&T's proposal could actually prevent the correction of cross subsidization, should it occur.

Currently, below band rates are included in the API calculation and price reductions are reversible in the current tariff period. There is no evidence that this limited flexibility has resulted in cross subsidy. Exchange carriers would not be incented to reduce prices under AT&T's proposal because doing so would trigger complex price regulation and limit an exchange carrier's ability to raise prices in the future. By requiring two sets of ongoing API calculations, AT&T's proposal would add unnecessary complexity. The only likely result of such onerous requirements would be to penalize exchange carriers for receiving additional downward pricing flexibility. In addition, an exchange carrier making a large price decrease one year would have to make price decreases in every subsequent year where the PCI is reduced by more than one percent. Given such undesirable effects, no exchange carrier is likely to make such price reductions.

AT&T attempts to illustrate that the removal of lower band limits, with or without the

one percent upper band limit, will result in a significant increase in prices.⁴⁸ However, this increase can only be demonstrated by using an unrealistic category revenue distribution (80 percent of revenue in the service category band experiencing price increase and 20 percent of revenue in the service category band experiencing price decreases). Reversing this revenue distribution to properly reflect the most likely condition of price decreases in high revenue categories or even just reducing this revenue distribution, shows that, in fact, no additional upward pricing flexibility results from the elimination of lower banding constraints.⁴⁹ This occurs even without the imposition of a one percent upper banding limit.

Exchange carrier customers will benefit from pricing flexibility. Not only will the exchange carrier be able to offer a more cost-based rate, but pricing flexibility will send proper market entry signals to competitors and provide for efficient allocation of resources. As GSA explained, any exchange carrier must know that it stands little likelihood of eliminating competitors through below cost pricing and that the likely effect of above cost pricing will be to hasten the challenge of competitors.⁵⁰ Thus, AT&T's proposals are not only unnecessary but are anticonsumer and anticompetitive and should not be adopted.

In addition to providing a penalty for reducing rates, the one percent limit on subsequent price increases will only serve to eliminate exchange carriers' abilities to utilize the market to set

⁴⁸Although the pricing flexibility amounts in AT&T's illustration are correct, the SBIs and the upper/lower band limits shown on Example 1 are incorrect for Band 2 because the previous price changes are not reflected in the SBI(t-1).

⁴⁹The most likely services for rate decreases (i.e., high capacity) generally account for 70 to 80 percent of the noninterconnection revenue in the trunking basket.

⁵⁰GSA at pp. 7-8.

prices. If price cap regulation is to replicate a competitive market, firms must be permitted to depend upon the market to determine the price of a service. This type of experimentation is an essential component of a competitive marketplace. These restrictions are unnecessary and should not be adopted.

3. Additional Pricing Flexibility is Warranted.

While many parties complained that pricing flexibility should not be granted in the absence of competition, USTA has shown that pricing flexibility is warranted even in the absence of competition to provide economic efficiency. USTA recommended that the Commission expand zone density pricing to Local Switching, Carrier Common Line (CCL) and the Residual Interconnection Charge (RIC) to further more prices toward cost. As Sprint observed, this would be “an even more effective tool for achieving cost-based rates.”⁵¹

4. Limited Changes to the Price Cap Basket Structure Should be Permitted.

In order to facilitate the economic pricing policies described above, USTA recommends that the Commission adopt a revised basket structure that would allow the grouping of rate elements for equivalent functions, facilitate pricing flexibility and readily accommodate new services. Again, parties opposed any changes without exhaustive and unnecessary demonstrations of competition.⁵² The limited changes proposed by USTA will not materially

⁵¹Sprint at p. 13.

⁵²MCI at p. 21, AT&T at p. 48, Time Warner at p. 23, and Ad Hoc at p. 29.

alter the current basket structure, but will allow for some much-needed simplification.

For example, USTA proposes to merge existing service categories, such as DS1 and DS3, where services share similar functional and market characteristics. The distinction between DS1 and DS3 is no longer needed. Contrary to CompTel's claims, merging these service categories will not result in increased prices for DS1s. The overwhelming majority of DS1s are purchased by the largest interexchange carriers. For the majority of price cap exchange carriers the percentage of DSIs purchased by the three largest interexchange carriers ranges from 69 to 92 percent.⁵³ It would not make sense for exchange carriers to raise prices for DS1s given that the impact would fall primarily on the largest interexchange carriers. The market provides the pricing discipline to such an extent that the requirement for separate service categories is no longer required.

5. Operator Services.

MCI argues that neither operator services nor call completion services will face significant competition.⁵⁴ Nothing could be further from the truth. Competition within the card and operator services segments of the industry has never been more intense. In fact, MCI in particular has spent millions of dollars promoting its 1-800-COLLECT offering as well as restructuring its customers to dial around the exchange carrier network.

⁵³For example, 89 percent of Nevada Bell's DSIs are purchased by the three largest interexchange carriers.

⁵⁴MCI at p. 20.

Prepaid and debit cards, intensely promoted by interexchange carriers, also bypass the exchange carrier network. Customers are instructed to dial access codes in order to qualify for discounts. Recent studies confirm that dial around calling is prevalent and is even used to make a significant number of intraLATA calls.⁵⁵

In addition, the majority of intraLATA operator-handled calls are made from payphone and other aggregator locations where display of information about the operator provider serving the location and the customer's right to access their carrier of choice are required. There are over 400,000 private payphones nationwide which generally use their own operator service providers for both inter and intraLATA calls. In fact, there are over 190 operator service providers nationwide serving the private payphone, exchange carrier payphone and aggregator markets.

AT&T claims that operator-related call completion services should be included in the operator service band proposed for the traffic sensitive basket and that directory assistance related call completion services be placed in the information service band to ensure that exchange carriers are not permitted to impose undue rate increases for these services.⁵⁶ Again, these services are subject to intense competition from interexchange carriers such that restrictive regulation is not required. USTA urges the Commission to treat operator services as recommended in its comments.

⁵⁵See, Comments of Ameritech, Bell Atlantic and NYNEX filed August 1, 1994 in CC Docket No. 92-77.

⁵⁶AT&T at p. 54.

IV. THE COMMISSION SHOULD ADOPT USTA'S RECOMMENDATION FOR AN ADAPTIVE REGULATORY FRAMEWORK.

It is certainly not premature to establish a regulatory framework that adapts to the level of competition present in the market, including allowing for streamlined and nondominant regulation. USTA's recommendations in this regard are conservative and pose no harm: relaxed regulation would be dependent upon an exchange carrier showing that customers were addressable by competition. As Schmalensee and Taylor explain, "we reiterate our concern that litigating the state of competition in each carrier access market will not be a fruitful way to proceed. In order that all competitors in these markets have similar abilities to match each other's service offerings and prices, it is necessary to rely on simple structural standards for streamlined regulation and nondominant treatment combined with the monitoring of behavior in the markets afterwards. Otherwise, LECs will be unable to respond to increased competition in particular services and in particular areas, and customers will be slow to receive any of the benefits of heightened competition."⁵⁷ In fact, given the rapid pace of change in the telecommunications industry, as described earlier, it is imperative that the Commission establish such a framework as soon as possible.

The comments clearly explain the danger in delaying adaptive regulation as proposed by USTA.

Because 'competition is the best regulator', most economists favor eliminating price regulation as soon as actual or potential competition limits the exercise of market power. In determining whether an industry is suitable for deregulation, economists generally do not require that an industry has the characteristics of a perfectly competitive market...In making the determination

⁵⁷Schmalensee and Taylor Reply at p. 2.

to remove a service from price cap regulation, the Commission should err on the side of the market for two reasons. First, by waiting for even more competition to materialize, the Commission risks denying the benefits of that competition to consumers that enter into long term relationships with suppliers in a regulated environment. Those consumers would be better off if the LEC and alternative providers could compete for their demands. Second, the decision to ease regulatory constraints does not have to be permanent. The Commission could re-impose regulations if market forces prove inadequate. Accordingly, the Commission should use this proceeding as an opportunity to set basic rules for the removal of services from price cap regulation as soon as there is a demonstration of a competitive alternative.⁵⁸

Thus, exchange carriers should be permitted to demonstrate that a particular service, geographic area or customer have competitive alternatives. The criteria for assessing competition should be addressability. A market is addressable when customers have alternative providers so that a price increase by the exchange carrier would be unprofitable.⁵⁹ Streamlined regulation is appropriate for markets when at least 25 percent of demand can be provided by alternative carriers and nondominant regulation is appropriate when at least 50 percent of demand can be provided by an alternative carrier and state requirements are met.

V. THE FLOW-THROUGH OF ACCESS CHARGE REDUCTIONS SHOULD BE REQUIRED.

As stated in USTA's comments, access charge reductions should be flowed through to end users on a dollar for dollar basis in order to maximize customer benefits.

⁵⁸Comments of Bell Atlantic, Affidavit of Richard J. Gilbert and Robert G. Harris at pp. 16-17.

⁵⁹This is consistent with the 1992 DOJ/FTC Horizontal Merger Guidelines.

VI. CONCLUSION.

Other than unsubstantiated predictions of dire consequences, the record does not contain evidence that the adaptive framework proposed by USTA, which is consistent with the Commission's proposals, will pose any harm to customers or competitors. To the contrary, the more rapid introduction of new access services and implementation of pricing flexibility will promote economic efficiency, send correct market signals to entrants and incumbents and provide customers with more options. This should take place irrespective of competition. These changes will not increase the exchange carrier's ability to engage in any type of anticompetitive behavior, but will ensure that all competitors and potential competitors are treated equally.

An adaptive regulatory framework will further benefit customers if regulation is reduced based on the degree of competition present in a relevant market area. The Commission should institute streamlined and nondominant regulation when the simple structural criteria proposed by USTA are met and monitor the impact of competition in order to ensure that customers receive the full benefits possible in a competitive market. Price cap reform must not be delayed. USTA urges the Commission to adopt USTA's adaptive regulatory framework.

Respectfully submitted.

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**PRICING FLEXIBILITY FOR
INTERSTATE CARRIER ACCESS SERVICES:
REPLY COMMENTS**

by

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Table of Contents

I.	INTRODUCTION.....	1
II.	ADDITIONAL PRICING FLEXIBILITY IS WARRANTED WITHOUT A COMPETITIVE SHOWING.....	2
III.	THE PRODUCT AND GEOGRAPHIC MARKET DEFINITIONS SHOULD NOT BE LIMITED TO NARROW DEFINITIONS.....	5
	A. Resale precludes inefficient or anticompetitive price discrimination.....	6
	B. Carrier access is undeniably an intermediate service.....	8
	C. Standards for Competitive Intensity.....	10
IV.	COMPETITIVE INTENSITY SHOULD BE MEASURED SIMILARLY FOR ALL COMPETITORS.....	12
V.	PRICE REGULATION REQUIRES LESS DEPENDENCE ON ACCOUNTING COSTS.....	15
VI.	CONCLUSIONS.....	18

**PRICING FLEXIBILITY FOR
INTERSTATE CARRIER ACCESS SERVICES:
REPLY COMMENTS**

I. INTRODUCTION.

In its Second Further Notice,¹ the Federal Communications Commission (Commission) sought comments on proposed reforms to its regulation of local exchange carrier (LEC) interstate carrier access services. In response, competitors generally criticized proposed increases in pricing flexibility or movements towards streamlined regulation, citing concerns about possible exploitation of market power over customers or services not subject to effective competition.

Our comments² on behalf of the United States Telephone Association (USTA) had three principal themes. First, more rapid introduction of new access services and implementation of competitive pricing plans would enhance competition in current access markets, irrespective of the degree of potential or actual competition in those markets. Second, relaxation of current regulation would lead to better outcomes for consumers if it were tied to the emergence of effective competition in each product and service market: when entry barriers are absent, streamlined regulation would be appropriate for markets in which at least 25 percent of demand can be served by an alternative carrier. Regulation as a nondominant carrier would be appropriate if at least 50 percent of carrier access demand were addressable by more than one carrier. Third, application of regulatory relief is forward-looking, and a backward-looking assessment of market power is inherently biased. Thus, rather than debate indicia of competition, a more pragmatic approach is required: institute streamlined and non-dominant regulation when simple structural criteria are met and monitor the development of competition in each market.

In reply to other parties' economic criticisms, we make five points. First, implementation of carrier access pricing and regulatory reform should take place irrespective of the degree of competition in any market because competitors and potential competitors would

¹ Price Cap Performance Review for Local Exchange Carriers, Treatment of Operator Services Under Price Cap Regulation, and Revisions to Price Cap Rules for AT&T, 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, Released September 20, 1995 (Second Further Notice).

² Richard Schmalensee and William Taylor, "Pricing Flexibility of Interstate Carrier Access Services," Attachment 1 to the Comments of the United States Telephone Association in CC Docket Nos. 94-1, 93-124, and 93-197, filed December 11, 1995 (Schmalensee-Taylor Comments).

be treated more equally under such regulation. These actions would not increase the incumbent LEC's ability to exploit its residual market power. Second, there appears to be some agreement that the appropriate product markets are wider than those proposed in the Second Further Notice while the appropriate geographic markets are smaller. However, proposals to incorporate "bottleneck services" into a product market definition are misguided because the addressability criteria we propose do not involve any so-called bottleneck service. Whether or not such concerns may be relevant for assessing the intensity of local competition, they have no relevance in the carrier access markets, particularly for high-volume customers. Third, competitive intensity should be gauged similarly for similar firms, and USTA's 25 percent proposal is reasonable by those standards and conservative in light of the particular circumstances of the carrier access market. Fourth, while price cap regulation -- as practiced -- may not remove every vestige of a link between accounting costs and price cap indices, it effectively eliminates the ability and incentive to cross-subsidize competitive services. This is because the effect of an accounting loss in a competitive service on the price cap index for less competitive services is tenuous, uncertain and unreliable, and, in particular, unknown at the time the firm would have to commit to an unprofitable price for a competitive service. Finally, we reiterate our concern that litigating the state of competition in each carrier access market will not be a fruitful way to proceed. In order that all competitors in these markets have similar abilities to match each others' service offerings and prices, it is necessary to rely on simple structural standards for streamlined regulation and nondominant treatment combined with the monitoring of behavior in the markets afterwards. Otherwise, LECs will be unable to respond to increased competition in particular services and in particular areas, and customers will be slow to receive any of the benefits of heightened competition.

II. ADDITIONAL PRICING FLEXIBILITY IS WARRANTED WITHOUT A COMPETITIVE SHOWING.

USTA proposed that certain baseline changes to carrier access regulation take effect regardless of the level of competition in the market. These changes have the effect of producing an outcome closer to the competitive outcome in markets where the dominant LEC is not yet

subject to effective competition. In the words of GSA, increased flexibility provides two advantages:

It allows carriers to set prices closer to the corresponding levels of cost, and it provides ratepayers with greater options in the manner in which they buy services. (GSA at 5)

In addition, these modifications will set proper signals for entry and exit and permit firms to compete fairly on the basis of their ability to provide services desired by customers at low cost. Such competitively-neutral regulation would require modification of the Commission's Part 69 Rules for new services, reduced regulation of alternative pricing plans (including volume and term discount plans and contract services in response to an RFP), and removal of lower service band index limits. Without these changes, LECs would continue to be handicapped in their ability to provide new services or lower prices, and customers would ultimately be denied these benefits.

There is little downside risk stemming from the proposed baseline regulatory reforms. LECs receive no additional ability to raise prices across the board under the baseline proposals, and any additional rate increase made possible by additional downward pricing flexibility remains limited by the annual 5 percent upper band limitation. Moreover, as observed by one consumer

(t)he danger of relaxing regulation in the absence of competition is that the carrier may use its new-found freedom to increase rates where demand is particularly inelastic, thereby abusing its pricing power. However, a careful review of the specific proposals outlined in the Notice reveals no instance where this danger is imminent. (GSA at 5).

Finally, the additional flexibility sought is not the ability to exploit market power but rather the ability to respond to competition in the same ways that firms in unregulated, competitive markets respond. Volume and term discounts are pervasive marketing tools in competitive markets (e.g., airline travel, auto rentals, hotel accommodations, computer software), in public utilities (e.g., retail electric and gas services), and in other telecommunications markets (e.g., cellular and domestic long distance). Such discounts are fully consistent with competitive markets, and -- as long as retail services can be resold without restriction -- these discounts need not be tied to measurable

differences in costs.

On the other hand, competitors such as AT&T, MCI, Time-Warner, MFS, Teleport, and National Cable Television Association (NCTA) advocate retaining restrictions on the rapid implementation of new LEC services and the LECs' use of volume and term discounts through Alternative Pricing Plans (APPs). However, one large customer, which does not compete with LECs in the supply of access services, supports our contention that baseline reform should be implemented without a competitive showing and that the limitation of contracting authority to streamlined services might actually retard the development of competition:

(i) it is possible that price cap services, which are normally subject to LEC market power, might become competitive in the context of large contractually determined packages of services. Accordingly, GSA recommends that the Commission qualify contract service for streamlined regulation based on the competitiveness of the contract itself, not the constituent services within the contract. (GSA at i-ii).

Even under the baseline regulatory reforms, there remain effective regulatory safeguards against anticompetitive prices. As we argue later, price cap regulation, itself, effectively removes any significant ability to offset losses for competitive services by higher prices for less-competitive services. In addition, even if continued state or federal regulation did provide some foreseeable -- though uncertain -- circumstances under which losses from pricing competitive access services below cost could -- in theory -- be mitigated by increases in other telephone prices, such a result flies in the face of regulatory experience. In a joint affidavit concerning out-of-region transport for video services, Drs. Alfred E. Kahn and William E. Taylor observed that

even under full-blown, instantaneously effective traditional rate of return regulation, and even if there were some residual joint or common costs between its competitive out-of-region operations and its in-region local exchange services, there would still be no means by which [the LEC] could recover net revenue reductions from the one in prices for the other. The widespread practice of regulatory commissions allocating aggregate revenue requirements among the several categories of service for purposes of regulating their prices is -- whatever else may be said about it -- an effective safeguard against subsidization of competitive operations at the expense of monopoly services. Indeed historically -- and still today -- the preponderant tendency of regulatory commissions has been to allocate common costs in such a way as to cross-subsidize in the opposite direction -- overburdening discretionary and competitive or potentially competitive

services in order to hold down the charges for basic monopoly services.³

III. THE PRODUCT AND GEOGRAPHIC MARKET DEFINITIONS SHOULD NOT BE LIMITED TO NARROW DEFINITIONS.

In any appraisal of the intensity of competition and the persistence of market power for telecommunications services, definition of the scope of the product and geographic market is essential. Regarding the product market, Dr. Bernheim (representing AT&T) criticizes the Commission's proposed market definition because it defines "separate product markets for distinct service components, rather than for integrated services"⁴ and "treats the individual components of access as if they were separate, unrelated services."⁵ In general, we agree that LECs should not be so limited, and we argued in our comments that

as the Second Further Notice recognizes (in ¶ 116), a relevant product market includes services that are readily substitutable for one another and to which a customer would turn if the price of one service were increased. The FCC's proposed product market definitions are inconsistent with that approach. (Schmalensee-Taylor Comments at 19-20).

Current access categories and subcategories were designed for convenience in tariffing a service that was not subject to serious competition in 1983, and those categories bear no relationship with economic product markets.

As outlined in our comments, we also believe that geographic markets should be defined based on a competitive footprint. We agree that the LECs could retain market power over

³ A.E. Kahn and W.E. Taylor, Affidavit to the U.S. District Court for the District of Columbia on behalf of Bell Atlantic Corporation in *United States of America v. Western Electric Company, Inc. and American Telephone and Telegraph Company*, (regarding relief from the interLATA restrictions of the MFJ in connection with the then pending merger with Tele-Communications, Inc. and Liberty Media Corporation), filed January 14, 1994.

⁴ B. Douglas Bernheim, "An Analysis of the FCC's Proposal for Streamlined Regulation of LEC Access Services," Appendix A to the *Comments of AT&T Corp.*, CC Docket Nos. 94-1, 93-124 and 93-197, filed December 11, 1995, at 3 (Bernheim).

⁵ Bernheim at 1.

customers that cannot connect to a competitive access provider (CAP) or interexchange carrier (IXC) network but note that

- our expansion of the product market to include customer characteristics eliminates this problem because additional pricing flexibility would be applicable only to high-volume customer locations,
- the proposal errs on the side of caution. It does not call for generalized pricing flexibility for even high-volume customers until a substantial fraction of demand in the wire center does have such alternatives, and
- the LECs could not use their additional pricing flexibility to raise access prices to these customers: access prices would remain controlled by the price cap formula, and reductions in prices through contract tariffs or APPs would not have the effect of lowering the average price index (API) in the price cap basket.

A. Resale precludes inefficient or anticompetitive price discrimination.

A consequence of this error, in Dr. Bernheim's view, is that the Commission does not establish product market definitions based on consumer characteristics and thus "fails to account for the potential effects of price discrimination in a reduced regulatory environment."⁶ Again, we agree that the product market should take customer characteristics into account, mainly because the set of substitute access services purchased by high-volume end-user locations can be very different from the set of services chosen by low-volume end-user locations:

Customers that originate or terminate large volumes of interexchange traffic generally use a different technology to reach IXCs than do customers having only small volumes of traffic...By the *Merger Guidelines* market definition, then, customers having sufficient volume to support dedicated access services should be treated as a separate market from small customers...that are restricted to switched access. (Schmalensee-Taylor Comments at 23).

We are less concerned than Dr. Bernheim about the possibility of inefficient or anticompetitive price discrimination across customer classes. There are no technological or regulatory barriers that prevent or retard resale of LEC interstate carrier access services, and

⁶ Bernheim at 3.

resale

is a sufficient safeguard against undue price discrimination through volume and term discounts. As long as the volume and term discounts are available for resale, arbitrage will ensure that the differential between a LEC's high-volume, long-term prices and its low-volume, short-term price is efficient. (Schmalensee-Taylor Comments at 11).

The Commission has long recognized the importance of resale in disciplining price discrimination in favor of high-volume customers, extending its abolition of resale restrictions on private line services⁷ to all public switched network services, including WATS and MTS, in 1980.⁸ The Commission intended that resellers would introduce intrabrand competition, purchasing WATS, a discounted bulk service, and selling portions of its capacity to smaller users as an MTS-type service. With resale competition in place, AT&T could not offset excessive discounts to high-volume customers with high prices to low-volume customers because efficient resellers could aggregate traffic from low-volume customers and compete successfully in the low-volume market. In addition to these benefits of lower rates and improved network usage, the Commission expected resale to increase innovation and deployment of new technologies.⁹

The same principles apply to the carrier access markets. As we noted in our comments,

(i)f the volume and term discounts are inefficiently large, a reseller could aggregate traffic—over both customers and time—to qualify for volume and term discounts, and if it could perform this function at a lower cost than a LEC, it would exert intrabrand pricing pressure on a LEC's low volume services until the price differential fell to a competitive level. (Schmalensee-Taylor Comments at 11).

Note that nothing in these principles requires that the underlying markets for carrier access services

⁷ Regulatory Policies Concerning Resale and Shared Use of Common Carrier Services and Facilities, Report and Order, 60 FCC 2d 261 (1976). The Commission explicitly stated that resale does not refer to the private line arrangements other common carriers (e.g., MCI) provide to customers (at 264). In addition, the Commission determined that unlimited resale was not appropriate for switched services at this time (at 290).

⁸ Regulatory Policies Concerning Resale and Shared Use of Common Carrier Domestic Public Switched Network Services, CC Docket No. 80-54, Report and Order, 83 FCC 2d 167 (1980). The Commission noted that the resale of private line services "has not produced any harmful effect on the AT&T or the public at large." (at 172)

⁹ Ibid at 172 (1980).

be effectively competitive. Intra-brand competition is sufficient to discipline the price differences among customer classes, so that a dominant firm can offer volume and term discounts without exposing customers to inefficient or anticompetitive price discrimination. For these reasons, AT&T was granted flexibility to file alternative pricing plans subject to resale requirements -- in the form of optional calling plans and contract tariffs -- several years before the Commission determined that competition was effective in the interexchange market.¹⁰

B. Carrier access is undeniably an intermediate service.

In Dr. Bernheim's view, a second consequence of the Commission's error in defining the product market too narrowly is the failure "to recognize that that individual service components are intermediate services rather than final services."¹¹ From this error, Dr. Bernheim reaches two conclusions: (i) that because carrier access includes "bottleneck services," relevant product markets must be defined for all final services that use any intermediate service, and (ii) that the market definition excludes substitute services that "do not require directly comparable service components,"¹² so that two final services could be close substitutes but make use of entirely different access services.

The first conclusion does not apply to the carrier access markets in question and -- if we understand it -- appears to be wrong as a matter of economics. In economics, control of a bottleneck service -- which we take to be equivalent to the antitrust concept of an essential facility -- does impose certain obligations on the owner to make the facility available to competitors on reasonable terms and conditions. In this analysis, a service or function is classified as an essential facility only when a competitor *requires* that service in order to compete (in some other market) with its provider, and the service is only available from that provider.¹³ In these circumstances, barring some reason why the service should not be made

¹⁰ See Schmalensee-Taylor Comments at 6-7.

¹¹ Bernheim at 4.

¹² Bernheim at 5.

¹³ A similar characterization is presented in W.J. Baumol and G. Sidak, *Toward Competition in Local Telephony*, Cambridge, MA: The MIT Press, 1994, at 93.

available to competitors, the provider of the essential facility should be required to offer it to all competitors on non-discriminatory terms, i.e., the same terms upon which it provides it to its own retail operation. The economic logic behind this requirement reflects an implicit cost-benefit analysis: that the cost to society of limiting the provider's property rights in its essential facility is outweighed by the gains to society from the competition made possible in the downstream, retail market.

First, while some LEC facilities are properly treated as essential facilities in some markets, LECs do not necessarily possess essential facilities in all carrier access markets. When a CAP or an IXC supplies carrier access to a customer location, there is no remaining LEC essential service relevant to this transaction. If IXCs have multiple sources for facilities to originate or terminate calls to particular customer locations, then LEC loops, switches or transport are not essential facilities for such customers, and the LEC cannot control the price paid for access to such locations. Thus, the proportion of market demand that can be served by alternative providers is a direct measure of (i) market power in the relevant carrier access market and (ii) the degree to which any LEC facility is essential in the supply of long distance services in that geographic and product market.

As a matter of economic theory, Dr. Bernheim's proposal to extend the definition of the carrier access product market forward into the retail toll market cannot be literally correct. Carrier access and toll are not substitutes and additional competition among carrier access suppliers has no effect on a toll provider's ability to control the market price of toll.¹⁴ Thus, it cannot be Dr. Bernheim's intention to include carrier access and retail toll services in the same product market. Nor would it be correct to withhold pricing flexibility and streamlined regulation in the carrier access market because of observed market power in a retail toll market. If IXCs have multiple sources for carrier access facilities, then the LEC would be unable to affect the market price for carrier access irrespective of its ability to affect the market price in

¹⁴ Certainly where essential carrier access facilities are present, it is possible -- under certain circumstances -- for a LEC to increase profits by leveraging its market power in carrier access downstream into the retail toll market. Hence it is not wrong, in principle, to examine retail markets for evidence of exploitation of market power originating in the carrier access market. Only in special cases can a monopoly supplier of an input increase its profits by integrating forward into the retail market and exploiting its input monopoly. See, e.g., D.W. Carlton and J.M. Perloff, *Modern Industrial Organization*, Second Edition, New York: HarperCollins, 1994 at 509-520.