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

# REPLY COMMENTS OF BELLSOUTH TELECOMMUNICATIONS, INC.

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January 11, 1996

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**REPLY COMMENTS**

BellSouth Telecommunications Inc. ("BellSouth") hereby submits its Reply Comments in the above referenced proceedings.

## I. SUMMARY AND INTRODUCTION

The Second Further Notice of Proposed Rulemaking demonstrated a willingness by the Commission to lay a foundation for the displacement of regulation by the operation of competitive market forces.[1] Not content with regulatory adjustments that lag significantly behind the exigencies that compel change, the Commission sought to define a forward-looking regulatory paradigm that anticipates and expects change. In this way, the Second Notice represents a major advance in regulatory policy making.

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[1] In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1; Treatment of Operator Services Under Price Cap Regulation, CC Docket No. 93-124; and Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197; Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1; Further Notice of Proposed Rulemaking in CC Docket No. 93-124; and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, FCC 95-393, released September 20, 1995 ("Second Notice").

BellSouth, in its Comments, applauded the Commission's recognition of and response to the dynamic changes and emerging competition for exchange access. BellSouth supported the overall approach outlined in the Second Notice. The essence of the Commission's proposals was to make its system of LEC price regulation more efficient and to encourage the development of competitive conditions in both the interstate access and local exchange market segments by reducing regulation as barriers to entry are lowered and competition increases. By making some simple and straightforward changes to the price cap plan, the Commission can set a framework for transitioning the LECs out of regulation, even while it sets the stage for a number of other broad reforms.

Remarkably, a number of commenters oppose the Commission. They perceive no room to improve the performance or efficiency of the price cap rules. In their view, considering and adopting a regulatory framework that adjusts regulation to competition is premature. These commenters would have the Commission believe that the time to begin considering pricing flexibility issues is after the competitors are firmly established. In other words, the Commission's policies and rules should lag the marketplace.

In this Reply, BellSouth shows that the comments opposing change simply have failed to present any cogent argument for deferring the type of price cap enhancements that BellSouth and others have recommended. The public interest is served by regulatory policies that recognize a changing environment and that can adapt to that environment. Indeed, the purpose of the Second Notice was to establish an adaptive regulatory framework. Contrary to the view of some commenters, it is not premature to establish an

adaptive regulatory plan now. Many parties would have the Commission believe that competition is some distant event that will be a long time in coming. This simply is not the case.[2]

As BellSouth demonstrates below, none of the commenters opposing change can articulate why price cap modifications that improve the performance of the price cap rules are contrary to the public interest or the Commission's objectives. In addition, BellSouth submits two attachments. The first, a paper by Dr. John Haring and Dr. Jeffry Rohlfs,[3] shows that affording LECs greater pricing flexibility now makes economic sense and is prudent regulatory policy. The second attachment, the Reply Statement of Dr. Jerry Hausman,[4] responds to the comments submitted by Mr. William Montgomery on behalf of the Association for Local Telecommunications Services and Dr. Douglas Bernheim on behalf of AT&T. In his response, Dr. Hausman affirms his initial conclusion that providing LECs with increased pricing flexibility in order to lower prices benefits

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[2] For example, in Georgia alone, nine companies have filed for authority to provide local exchange telephone service, with three applications already approved including those of MFS and MCI's local affiliate MCI Metro. Likewise competitive fiber networks are expanding at an accelerated pace. Brooks Fiber, a provider of competitive local telecommunications services in intermediate-sized tier II and tier III cities, recently announced that it would build its 20th metropolitan network in Jackson, Mississippi. The network will be completed by the first quarter 1996. This latter example evidences that competition is not confined to large urban centers and that new entrants can be operational within short periods of time.

[3] John Haring and Jeffrey H. Rohlfs, Strategic Policy Research, Comments On Pricing Flexibility Issues, (January 10, 1996) ("Haring/Rohlfs Paper"). This paper is attached hereto as Attachment 1.

[4] Reply Statement of Professor Jerry A. Hausman (January 9, 1996) ("Hausman Reply Statement). The reply statement is attached hereto as Attachment 2.

consumers and is procompetitive. Dr. Hausman further shows that subjecting LECs to extreme standards to obtain streamlined regulations, such as those advocated by Dr. Bernheim, are premised on unsound economics and will result in unnecessary regulation.

## II. IMPROVING THE PERFORMANCE AND EFFICIENCY OF THE PRICE CAP RULES IS NOT DEPENDENT ON THE ACHIEVEMENT A COMPETITIVE THRESHOLD

The Second Notice suggested a number of areas within the price cap rules that should be characterized as baseline changes, which if made, would improve the performance and efficiency of the LEC price cap plan. The baseline changes should be made because they will result in a regulatory framework that more closely resembles the competitive model—the ultimate objective of regulation.

Along these lines, BellSouth advocated that the Commission make modest changes in three specific areas:

- Modification of the new service rules coupled with modification of the Part 69 waiver process;
- Modification of service category definitions and lower banding requirements;
- Extension of zone density pricing to all baskets and service categories.

These baseline improvements will better achieve the Commission's price cap policy goals, including realization of increased efficiency, reasonable nondiscriminatory rates and minimal regulation.

Several non-LEC parties contend that no baseline changes are needed because competition is not fully developed.[5] Such comments, however, miss the mark. The baseline changes are not dependent on the presence of competition and, indeed, should be made in the absence of competition.[6] All of the baseline changes would improve the performance of the price cap rules. What these parties overlook is that the only reason that the price cap rules are necessary at all is because competition and market forces are not yet a sufficient check on LEC conduct. Were full competition present, as these parties suggest is required, then the relevant inquiry would not be how to improve the price cap rules, but rather, how to relax and remove regulation. Thus, those parties that proclaim that there is no competition for exchange access, a statement with which BellSouth does not agree, have provided the very reason why the Commission should adopt the baseline changes to improve the performance of regulation.

AT&T claims that the lack of exchange access competition is justification for the Commission not to spend any resources on improving the LEC price cap plan. It argues that the Commission should instead focus on removing subsidies from access prices, and that such reforms must precede price cap reform.[7] While BellSouth has long advocated that the Commission commence a universal service proceeding and an access reform proceeding as essential to the transition to the competitive marketplace, AT&T is simply mistaken to presume that price cap improvements can or should await the outcome of

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[5] See e.g., AT&T; TRA; TWC; CCTA; Ad Hoc.

[6] Haring/Rohlfs Paper at 4-5.

[7] AT&T at 5-8.

some future proceeding. Neither universal service nor access reforms are a substitute for or more important than improving the price cap rules.

Nothing in the baseline changes recommended by BellSouth is inconsistent with universal service objectives or access reform. Universal service and access reforms do not obviate the need for the proposed price cap modifications. It would simply be irrational to disregard all the efforts here and postpone action on the price cap modifications that are both independently necessary and complementary to universal service and access reforms.[8]

The vacuity of the arguments against any baseline change to the price cap rules becomes all the more apparent when these arguments are viewed against the backdrop of specific proposed modifications. For each baseline change, the non-LEC parties play variations on a single theme--no improvement can or should be made in the LEC price cap rules. It is all too obvious that imperfect and inefficient regulation better suits the business plans of these commenters. The regulatory scheme that these commenters would have the Commission follow does nothing to establish the Commission's stated goal of a firm regulatory foundation for a transition to competition.

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[8] For example, permitting zone pricing on carrier common line would provide LECs with an opportunity to establish more efficient prices pending resolution of universal service issues. Likewise, new services relief is only a partial step to access reform. Nothing in access reform could alter the importance of new services to the realization of the Commission's objectives, nor could access reform ever validate current rules.

### A. New Services

From the inception of the price cap rules, new service introduction has been considered by the Commission as an important contributor to improving the efficiency of price cap regulated firms. Accordingly, rule modifications that would stimulate and facilitate new service introductions would improve the performance of the price cap rules. BellSouth proposed modifying the rules in two important ways. First, the price cap rules should be modified to permit the filing of new services on fourteen days notice supported by direct cost information. Second, but equally important, the Part 69 rules should be modified to permit the establishment of new rate elements associated with new services as defined in the price cap rules.

Several of the non-LEC parties object to any modification of the new service rules. Some focus on cost support, contending that all new services should be accompanied by adequate cost support.[9] In fact BellSouth has suggested that all new services be supported by a showing of direct costs. Accordingly, BellSouth's proposal should remove any objection to new services relief that these parties may have.

Both MCI and AT&T believe that the LECs must continue to justify overhead loadings for new services.[10] Indeed, MCI goes so far as to urge the Commission to specify guidelines or in the alternative to treat overhead loadings as an exogenous adjustment to the price cap index. The obsession that these parties have with overhead

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9 See e.g., AT&T at 22-26; MCI at 8-11; MFS at 2-4.

10 AT&T at 22-26; MCI at 8-11.

loadings brings into focus a significant flaw in the existing LEC price cap rules. The current rules currently provide that the rates for new services shall reflect no more than a just and reasonable amount of overhead costs.[11]

The comments of MCI and AT&T demonstrate the inappropriateness of the current rule and the misdirection to which it can lead. These parties are interpreting the current rule as a maximum price rule which it is not. They would have the price cap rules work as a surrogate for a fully distributed (FDC) cost methodology.[12] In effect, they want the Commission to specify the maximum "loadings" that can be reflected in the price of a new service. In this way, then, the price cap rules would establish the maximum new service price and, thus, have the same effect as was the case when the Commission followed FDC principles. The fact of the matter is that the price cap rules should not dictate the maximum prices for new services. Indeed, there is no need.[13] As defined in the rules, new services increase the options of customers. If the new service is priced too

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[11] Amendment of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, CC Docket No. 89-79, Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Order on Further Reconsideration, 6 FCC Rcd 4524, 4531 (1991).

[12] See Haring/Rohlfs Paper at 10-11.

[13] There are many factors that influence the price of new services. It is not merely a contribution to the recovery of joint and common costs. Other factors include a return to innovation and research and development. Thus, pricing is not a zero sum game as MCI's exogenous proposal would suggest.

high, customers will reject the offering in the marketplace. Thus, the marketplace provides the acid test as to the reasonableness of new service prices.[14]

Even if the Commission modified the price cap rules for new services as suggested by BellSouth, much of the improvement would be undercut by the existing Part 69 access charge rules that dictate the rate structure for switched access. The Commission recognized this effect by including as an issue in this proceeding changes in the Part 69 rules so that they do not limit new service introduction. The Commission's proposal was to modify the Part 69 waiver process, with the objective of simplifying and expediting the process so as to make new service introduction easier.

Regardless of the reason articulated in the comments, BellSouth suspects the real reason parties have objected to any improvement in the Part 69 rules is their goal to maintain as complex and cumbersome a regulatory process as possible. No effort is made by these parties to offer alternative approaches to improving regulation. To the contrary, their focus is in providing excuses for the Commission not to act.

BellSouth has advocated, and the Commission should adopt, as a primary principle of policy that new services be favored in the regulatory process. The Commission should remove unnecessary regulatory obstacles to their introduction. Part

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[14] Some parties argue that certain new services are essential, and therefore, the Commission should not modify any of the rules that pertain to new services. There is no need, however, for the Commission to approach new services as an "all or nothing" issue. BellSouth provided an approach that could accommodate those essential new services that the Commission mandates be provided. Having a class of excepted new services should not preclude providing a general rule that facilitates new service introduction.

69 rate structure rules present such an obstacle. The Part 69 waiver process represents nothing more than securing prior permission to make a tariff filing. Modifying the Part 69 rules to remove the need for filing a waiver would eliminate this superfluous and anticompetitive step.[15] Not only would such a modification vastly improve the efficiency of regulation but it would also bring regulation closer in line with the statutory framework of carrier-initiated rates, at least for new services.

### B. Basket And Service Category Changes

The non-LEC comments echo the familiar refrain that competitive developments for exchange access do not warrant any changes to the basket or service category structure.[16] For these parties, there is simply no performance or efficiency gains that can be obtained by changing the price cap rules.

These parties fail to acknowledge that the Commission itself recognized, when it first adopted price caps for the LECs, that a single basket without service categories would provide the greatest pricing efficiency. In establishing multiple baskets with service categories, the Commission was addressing specific regulatory concerns. Accordingly, the criterion that should be applied in evaluating any change is whether the particular regulatory concern remains and can only be accommodated by retaining the

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[15] BellSouth has proposed that the Commission modify the Part 69 rules to permit the establishment of rate elements for new services. Accordingly, BellSouth's approach ameliorates the procedural objection of those parties such as MCI and AT&T that the Commission cannot modify the legal standard for a waiver of the Commission's rules.

[16] AT&T at 45-48; CompTel at 33-35; MCI at 18-20; SPRINT at 22; TRA at 25-26; NCTA at 28-29.

existing basket and service category structure. It is not a question of whether or not effective competition exists.

BellSouth's proposed modifications, although modest, would improve the performance and realize the attendant benefits of price cap regulation. The proposal eliminates service categories that have no regulatory purpose but retains those for which there still are regulatory concerns. For example, in the transport restructure proceedings, the Commission has focused on the differences between dedicated and tandem switched transport. BellSouth's proposal would retain distinct service categories for these two forms of transport. BellSouth's proposal would, however, consolidate all the subcategories of dedicated transport because no regulatory purpose remains for their continuance. Moreover, technology and demand have singled out high capacity services as the preeminent transport services and, therefore, maintaining multiple service categories with separate pricing constraints is economically inefficient.

BellSouth's proposed changes to the traffic sensitive service categories are intended to make the category structure more efficient. For example, under the current rules, the database service category includes only a single service. This is also true for the BNA service category. These service categories are the equivalent of specific-service bands that were recognized as too restrictive when the LEC price cap plan was adopted in 1991.[17] BellSouth's proposal to enlarge the database subcategory to include 800 service, LIDB and other database type services and to move BNA to the information/DA service

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[17] Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786 (1990).

category broadens the service category definitions so that price management under the rules will be more efficient.

Those commenters who can find no improvements to the current rules are merely asking the Commission to settle for less than optimum rules. Such a result subverts the Commission's objective of establishing price cap rules that provide a transition to competition. It perpetuates rules that artificially and unnecessarily constrain LEC prices. While that result may be in the interest of specific commenters, it fails to meet Commission's responsibilities and goals.

### C. Banding Limits and Zone Pricing

It comes as no surprise that the most non-LEC parties oppose any additional pricing flexibility that might be afforded the LECs by removing lower pricing limits or extending zone pricing.[18] The reasons that these parties advance to support retaining the current limitations, however, make no sense. Some parties staunchly object to removing the lower pricing limits and providing the LECs with any downward pricing flexibility while, on the other hand, the same parties argue that access prices are too high and must be lowered.[19] This makes no sense. Increased downward pricing flexibility can do nothing other than reduce access prices.

Other parties view increased pricing flexibility as a means to engage in cross-subsidy. This alleged cross-subsidy is not cross-subsidy in any true economic sense. As

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[18] AT&T at 49-52; MCI at 21; CompTel at 32-35.

[19] MCI at 4-5, 21; CompTel at 5-9, 32-35.

long as the price of a service covers the direct cost of providing that service, the service is not being cross-subsidized. Given that these same parties argue that access prices are too high, it is clear that increased pricing flexibility does not bring with it a danger of pricing below direct cost.[20] It is readily apparent that their notion of cross-subsidy is clearly grounded in the outdated and discredited fully distributed cost notion that each and every price must be established at its fully distributed cost. The Commission has long abandoned this philosophy and has been resoundingly affirmed by the Courts; it should ignore any comments that long for its return.[21]

The additional pricing flexibility advocated by BellSouth improves the price cap rules as a transition mechanism to competition because it creates a framework of pricing rules that better replicates the outcomes of a competitive market. It permits LECs to establish more efficient prices.[22] It is precisely the replication of competitive market outcomes that should be and, indeed, is the objective of the Commission in formulating price cap rules.

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[20] Both Haring/Rohlfs and Hausman demonstrate that predation is an unlikely pricing strategy. Haring/Rohlfs Paper at 7-8; Hausman Reply Statement at ¶¶ 5-7.

[21] In its review of the first LEC Price CAP order, the Court of Appeals soundly rejected FDC pricing as required for just and reasonable rates:

> To the extent that MCI is obliquely making a claim that the statutory "just and reasonable" rate requirement mandates use of fully distributed costs and bars moves toward inverse elasticity prices, our precedent is squarely against it.

National Rural Telecom Association v. FCC, 988 F.2d 174, 184 (D.C. Cir. 1993).

[22] See Haring/Rohlfs Paper at 6-9.

## III. THE COMMISSION SHOULD PROCEED AND ADOPT RULES FOR RELAXING REGULATION AS COMPETITION DEVELOPS

The Second Notice recognizes the rapidity with which the telecommunications marketplace is changing. In anticipation of the dramatic changes still to come, the Commission seeks to have rules in place that can accommodate a wide range of situations that can arise as marketplace conditions change. Such forward-thinking represents a sound approach to regulatory policy. Rather than having to catch-up to the telecommunications industry, the Commission is wisely signaling its intent to lead and to have regulations that are flexible enough to keep pace with shifting conditions.

For those commenters that viewed baseline price cap changes as on the vanguard of regulatory radicalism, the idea of adaptive regulation falls just short of regulatory heresy. Hence, the prevailing theme around which these parties weave their arguments is that the Commission should postpone consideration of any rules that could lead to relaxed regulation of the LECs. From their perspectives, competition should develop first, and, then, the Commission can take up, in yet another proceeding, what, if any, rule changes should occur. In other words the Commission should abandon adaptive regulation and maintain a regulatory policy firmly grounded on reactive regulation.

Nothing in the comments should deter the Commission from its objective of establishing an adaptive regulatory plan now. Adaptive regulation facilitates the transition to competition.[23] As the Commission recognizes, competition displaces the

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[23] See Haring/Rohlfs Paper at 11-12. As Haring/Rohlfs state, "a well-conceived policy roadmap that lays out specific actions the government plans to implement in the event that contingencies actually occur makes for continuity in (Footnote continued....)

need for regulatory intervention. Indeed, regulation and competition are incompatible. Self-adapting regulatory policies will enable market forces to replace regulation as market conditions warrant.

By design, adaptive regulation does not get ahead of the market, as some commenters would suggest.[24] Instead, it removes the lag that characterizes traditional regulatory policies. The adaptive regulatory policies, in this case streamlining and non-dominance, would only be implemented when the LEC can demonstrate that the competitive conditions justify a reclassification. The Commission does not need to know the precise moment when a service will be reclassified in order for it to design and implement rules now that will permit relaxed regulation.

The focus of BellSouth's comments were on identifying the conditions that should trigger relaxed regulation. Important to this process is the recognition that the transition to competition will not be uniform from service to service or locale to locale. Such variability demands an approach that specifies criteria that are flexible enough to apply in a variety of circumstances. Simply put, the adaptive regulatory rules must allow for adjusting product and geographic dimensions of service segments that are candidates for reduced regulation to the way in which competition actually develops.

Perhaps, the most prominent flaw evidenced in the opposing comments is the lack of appreciation of the dynamic aspects that do and will continue to characterize the

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policymaking, increases the credibility of the government's policy program and promotes efficient investment by removing uncertainty about the governments policy plans.

[24] See, STV in toto; TRA at 22-23; TCG at 2-3, 7.

development of competition. The comments present competition in a static, uniform context. Hence, they often present preconditions to relaxed regulation which if codified in the Commission's rules, would introduce a rigidity that would diminish the effectiveness of an adaptive regulatory plan.

A prime example appears in those comments that advocate a checklist as a prerequisite for reduced regulation.[25] The concept of a checklist is a feature borrowed from the pending telecommunications legislation. In the legislative context, the checklist represents conditions that must be met in order for the former BOCs to enter the interLATA marketplace. In that context, the checklist is well suited because it addresses a uniform business constraint and a set of uniform conditions to lift the constraint.

In contrast, a checklist is not well-suited to an adaptive regulatory plan. A single checklist does not, nor can it, differentiate among the service segments for which competition is developing with differing rapidity. For example, several commenters contend that full local number portability (i.e., database capability) ought to be included in the checklist. Putting aside the issue of the reasonableness of the requirement in any checklist, there can be no question that such a requirement is unnecessary for and unrelated to transport competition. Alternate transport networks continue to expand in

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[25] For some commenters, the checklist would be a more extreme measure. Rather than act as a prerequisite for reduced regulation, the checklist would serve as a preliminary requirement that, after it is satisfied, would allow a separate proceeding to be commenced to determine if reduced regulation should be implemented. See e.g., MCI at 23-24, 29-30.

terms of the number of providers, locations served and traffic carried. To suggest that local number portability is a measure of competition for transport is irrational.

A checklist cannot reflect the variety of ways in which competition can develop. Many factors can effect the development of competition. Consolidations, mergers, business alliances and technological change can speed the competitive developments and render a checklist or at least elements within the checklist obsolete. Two years ago, who would have predicted, for example, that AT&T, in addition to being the largest interexchange provider, would also be one of the largest mobile telecommunications providers and would be pursuing an aggressive local market entry strategy through wireless and wireline resale opportunities. Similarly, Time-Warner's alliance with US West provides it with technical know-how, financial resources and the customer base to be a formidable local competitor. These types of events significantly influence competitive developments and are not easily predictable. A checklist cannot accommodate the unanticipated.

The regulatory penalty for a misspecified checklist is severe. If a checklist is incorrectly specified or becomes out-of-date with the marketplace, the regulatory consequence is that the checklist would have to be revised through the initiation of a new regulatory proceeding. From the viewpoint of a LEC competitor that is not subject to regulation, adopting a regulatory framework for LECs that builds-in the promise of more regulatory proceedings presents numerous business advantages, but nonetheless represents poor regulatory policy.

Adaptive regulation should incorporate rules that can accommodate diverse paths to competition in a way that will permit market forces to operate as conditions warrant. In the Second Notice, the Commission discusses three criteria, demand responsiveness, supply responsiveness and market share as criteria that it could apply in relaxing LEC regulation. These criteria are the same as those applied to AT&T. Many commenters support the idea of applying the same approach that was used to relax AT&T's regulation to the LECs.[26]

For the most part, BellSouth believes that the criteria identified in the Second Notice are a good starting point. As the Commission did in the case of AT&T, the Commission here must recognize that these criteria do not carry equal weight. Thus, for example, the Commission inferred demand responsiveness for AT&T's business services because of the sophistication of the customer base. In this circumstance, the overarching factor for streamlining AT&T's regulation was supply elasticity.

For interstate exchange access, the customer base is by far the most sophisticated technically knowledgeable group that exists in the telecommunications marketplace.[27] Thus, as in the case of AT&T, supply elasticity should be the key criteria for streamlining access services.[28]

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[26] See e.g., Ameritech; USTA; TWC.

[27] The majority of interstate access services is obtained by common carriers, some of whom are competitors of the LECs and all of whom are potential competitors. Non-carrier customers are generally the large telecommunications users who share the characteristics of business users in the interexchange market.

[28] Like AT&T, the Commission should infer demand responsiveness on the part of access users. There can be no question that the customers of exchange access are aware of the choices and alternatives that are available. From the inception of access (Footnote continued....)

Any plan for relaxed regulation must include provisions for declaring a LEC non-dominant in the provision of its services. A LEC should be declared to be nondominant when it is found not to possess market power for a particular market segment in a given geographic area. While the absence of market power is the standard the Commission has used in the past when considering issues of non-dominance, contrary to what most non-LEC commenters suggest, market share is not the best indicator of market power.[29]

In its comments, BellSouth submitted a statement prepared by Dr. Jerry Hausman. Dr. Hausman recommended that the Commission focus on demand and supply considerations, as well as market performance considerations.[30] He explains that while competitive conditions are important in a market power determination, market share is not a correct measure of such conditions. Instead, it is competition at the margin--and not market share--which determines prices.[31] This salient fact is overlooked by those parties that seek to tie regulatory relaxation to market share.

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charges, interexchange carriers have taken advantage of every opportunity to reduce the prices they pay for access services. For example, every change in a Commission rule that altered the relative price relationships between switched and special access brought with it a corresponding change in the demand for access services. The development of Megacom-type and 800 Ready-line type offerings are prime examples of the demand responsiveness in the exchange access market.

[29] Haring/Rohlfs show that reliance on market share as indices of competition would provide little information about competition itself. Haring/Rohlfs Paper at 14-15.

[30] See Statement of Professor Jerry A. Hausman (December 6, 1995) ("Hausman Statement") at ¶¶ 47-56, submitted as Attachment 1 to BellSouth's Comments.

[31] Id. at ¶¶ 53-54. As Dr. Hausman points out, if BellSouth were to attempt to keep its price 5 percent above the competition, it would only need to lose about 7 (Footnote continued....

The remaining controversy associated with an adaptive plan for reducing LEC regulation is associated with the product and geographic dimensions of such relief. The Second Notice framed its questions around relevant product and geographic markets. With regard to the geographic dimension, the non-LEC parties uniformly reject existing pricing zones as a starting point. The alternatives suggested range from street by street analyses[32] to LATAs.[33] It becomes immediately evident that the geographies being suggested are for the most part intended to delay the prospect for LECs receiving any regulatory relief.

For example, urging the Commission to adopt a large geographic area such as the LATA vests in the LECs' competitors virtually complete control of when, if at all, LECs would be entitled to reduced regulation. Simply, refraining from doing business in some portion of a LATA could prevent streamlined regulations in other areas in the LATA where the LEC faces substantial competition. Indeed, the fundamental flaw of the proposals that rely on large geographic areas is that they presume that in order for a competitor to be successful, it must have a ubiquitous network. They ignore the more likely scenario of a focus strategy where the competitor can concentrate its efforts in one or more geographic niches in the marketplace. Such a strategy is particularly effective when there is a high degree of market segmentation and when revenues are highly

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percent of its traffic for this price difference to be unprofitable, given the low marginal costs of most telecommunications services.

[32] See AT&T at 15.

[33] See e.g., Time Warner at 40-50; AD HOC at 30.

concentrated into relatively small portions of the product lines or geographic areas. Both of these conditions apply to access service.[34]

Just as large geographic areas are inappropriate, defining geographic areas too narrowly can be equally incorrect. AT&T has assumed this extreme position. It contends that only if there is an actual alternative source of supply should the area be considered competitive.[35] Thus, AT&T argues that if on one block there is an alternative access provider but on another block there is not, then geographic market should be confined to the block where there is an alternative access provider.[36] The obvious flaw in AT&T's position is that it presumes a static marketplace. It fails to consider expansion that is both technically and economically feasible within a reasonable surrounding geographic area.

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[34] Moreover, the evolution of competition in the transport segment evidences the operation of such a focused strategy.

[35] A corollary to AT&T's geographic recommendation is that if a larger geographic area were used than it proposes, then the Commission must require average prices between competitive and non-competitive areas. The putative reason offered by AT&T is to prevent discrimination. No such pricing limitation is necessary. With regard to the non-competitive areas, services provided in such areas would continue to be subject to price cap rules and their attendant price constraints protecting users in those areas. In competitive areas, the Commission has long recognized that competition serves to prevent discriminatory practices. The fact that users in non-competitive areas may not pay the same rates as users in competitive areas does not mean that there is an unreasonable discrimination. There is nothing in the Communications Act that requires uniform rates between two geographic areas. In this instance, the potential for different rates would represent implementation of policies the Commission has determined is in the public interest and, hence, any discrimination would be reasonable and sanctioned under the Communications Act. Finally, in no event would a LEC be able to discriminate against similarly situated customers, which should be the object of any Commission concern.

[36] In support of its position, AT&T submitted a paper by Dr. B. Douglas Bernheim. In his Reply Statement, Dr. Hausman refutes the positions advocated by Dr. Bernheim, Hausman Reply Statement at ¶21.

BellSouth suggested and continues to urge the Commission to adopt an approach that is based on exchange groups. The most reasonable expectation, and consistent with the experience in the transport segment, is that competition will develop in groups or clusters of exchanges. Use of an exchange group builds upon the basic LEC serving area but is not so rigid as to ignore the variation that will undoubtedly occur among different LECs as well as within a particular LEC's operating territory. BellSouth's approach is superior to those expressed by other commenters because it provides the Commission with an economically meaningful construct for the purpose of relaxing regulation and, more importantly, it is an area in which competition is in fact taking place.

With regard to the product dimension for relaxed regulation, most commenters agree that existing service categories are a good starting point.[37] AT&T, however, urges the Commission to adopt a product bundles approach recommended by its consultant Dr. Bernheim. According to AT&T, competition will develop for access components at differing speeds. AT&T further argues that some components, particularly the local loop, will remain bottleneck facilities. Separate bundles would be created for each access component and each service that uses a combination of components. A bundle would be a candidate for reduced regulation only when all components in the bundle is subject to effective competition.

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[37] In its Comments, BellSouth supported the use of service categories provided that its Baseline recommendations were adopted and that the common line basket be considered with the local switching service category. BellSouth at 45-48.

The Bernheim approach is flawed in several respects. The view that any access component is a bottleneck is suspect. Alternative access providers already connect large users to alternative transport networks. These connections are alternative loops that can easily be used to provide local exchange and switched access services. Likewise cable television companies have vast local networks with loop connections to residence and business users. CAPS, cable companies and interexchange companies separately or jointly can economically replicate LEC local networks.[38] It is simply a mischaracterization to suggest that the LEC has a bottleneck.

In any event, a more fundamental failure of Dr. Bernheim's approach is that it would unnecessarily sacrifice consumer benefits associated with competition. As Dr. Hausman points out in his Reply Statement, streamlined regulation is preferable even if certain building block components are not subject to competition as long as the correct regulatory rules exist.[39] Dr. Hausman recommends that imputation can be used for components where competition has not developed.[40] In this way, according to Dr. Hausman, consumer benefit enhancing competition for services can occur, even when competition on some components does not exist.[41]

In formulating its adaptive regulatory plan, the Commission must guard against those recommendations which seek to promote individual competitive positions rather

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[38] When the emergence of new wireless technologies and services is considered, no portion of the LEC network is essential.

[39] Hausman Reply Statement at ¶¶ 16-17.

[40] Id.

[41] Id.