incremental cost by sufficient amounts to pay for this revenue shortage as well as cover the joint and common costs. A price reduction in one service that is offset or partially offset by a price increase in another service and where the prices for both services cover their respective incremental costs, does not result in "cross-subsidization." AT&T and other parties incorrectly imply that access services where prices are being reduced are being subsidized by other access services. In reality, these competitors of the LECs can cite no LEC access services that are priced below cost.

In contrast to AT&T's position, AT&T has continually exerted substantial pressure in meeting after meeting with the LECs to reduce LEC access rates further. Thus, AT&T's contacts with the LECs squarely conflict with the assertions AT&T makes here to express newly-found fears of LEC "cross-subsidization." AT&T did not concern the Commission with its own alleged ability to cross-subsidize when it argued strongly for the elimination of the lower SBI limits that applied to AT&T. AT&T's assertions that LECs will engage in unreasonable cross-subsidization are unfounded and wrong.

2. AT&T's Proposal Would Inhibit Price Reductions.

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 current level of pricing flexibility has led to any cross-subsidization or other undesirable effects. Limiting subsequent price increases to 1% would have a severe dampening effect on the willingness of carriers to offer price reductions.[60] LECs will not likely reduce prices under such an environment because doing so would trigger more complex and restrictive price regulation that

[60] GSA, pp. 7-8.

limits LECs' ability to raise prices in the future. By requiring two sets of ongoing API calculations,[61] the AT&T proposal would create an administrative nightmare. The penalties on the LECs for the potential grant of additional downward pricing flexibility would likely cause the flexibility to go unused.[62] In addition, a LEC making a very large price decrease one year would then be forced to make additional price decreases in every subsequent year where the price cap index (PCI) is reduced by more than 1%. Thus, LECs would be less likely to make these reductions due to the undesirable effects of this AT&T proposal.

3. The Current 5% Upper SBI Limit Provides Proper Protections And Falls When LECs Lower Prices.

LEC customers will benefit from pricing flexibility.[63] Not only will the LECs be able to offer the best possible price in more circumstances, but full pricing flexibility sends proper market entry signals to competitors and provides for efficient allocation of resources. Time Warner opposes removing lower SBI limits that would allow the LECs to lower prices, asking instead that only the LECs' competitors be allowed to be the source of lower prices to access customers.[64]

The 5% upper SBI limit serves as adequate protection against so-called "monopoly" pricing and should be retained. AT&T's proposals would inhibit the rationalization

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[61] AT&T, fn. 86.

[62] "This constraint would virtually guarantee that every price reduction would generate a net income loss to the LECs." GSA, p. 7.

[63] Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786 (1990) (LEC Price Cap Order), para. 35.

[64] Time Warner pp. 7-8.

of rates. By preventing carriers from raising some rates when appropriate, the Commission's goals to encourage movement toward efficient rate levels would be thwarted.[65]

The lowering of prices automatically reduces the upper SBI limit in the next annual filing by the full amount of the price reduction. Thus, the proposed 1% upper SBI limit is inappropriate. For example, reducing prices by, say, 12% in one year reduces the upper SBI limit by 12% and only allows the LEC to subsequently raise the reduced prices in the next year by the change in PCI plus five percent. If the change in the PCI was negative (i.e., the productivity offset was greater than the inflation adjustment), then the upper SBI limit (the maximum allowed average price) would fall by over 7% in the following year. Thus, even absent customer reactions, existing price cap mechanics cause the LEC to have little ability to subsequently increase prices after making a significant price reduction. As GSA correctly noted,[66] any LEC must know that it stands little likelihood of eliminating competitors through below cost pricing and the likely effect of above cost pricing will be to hasten the challenge of competitors. As a result, the Commission need not and should not adopt the proposal to further limit price increases following price reductions.

4. The AT&T Price Cap Examples Distort The Effects Of Pricing Flexibility By Misrepresenting Typical LEC Revenue Distributions.

As rationale for its suggested restrictions, AT&T (Appendix B) attempts to illustrate that the removal of lower band limits, with or without the imposition of a 1% upper

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[65] GSA, p. 7.

[66] GSA, pp. 7-8.

banding limit, will result in a significant increase in upward pricing flexibility.[67] This purported upward pricing flexibility increase was demonstrated by using a totally unrealistic service category revenue distribution (80% of revenue in the service category [band] experiencing price increases and 20% 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 equalizing the revenue distribution, shows that in fact no additional upward pricing flexibility results from the elimination of lower banding constraints.[68] This occurs without the imposition of a 1% upper banding limit.

Thus, the proposals to limit price increases following price reductions are not only unnecessary but they may preclude the LECs from making legitimate price increases and should not be adopted.

N. Recommendations To Reduce Or Eliminate The Interconnection Charge Should Not Be Considered In Isolation.

As SWBT demonstrated in 1993, the costs recovered in the Interconnection Charge in the interim rate structure are legitimate costs of providing transport service to all markets within SWBT's study areas.[69] Included in these costs are the booked interstate

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[67] Although 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 since the previous price changes are not reflected in the SBI(t-1).

[68] The most likely services for rate decreases (i.e., High Capacity) generally account for 70% to 80% of the non-interconnection revenue in the trunking basket.

[69] SWBT Comments, CC Docket No. 91-213, Transport Rate Structure and Pricing, filed February 1, 1993, pp. ii, 32-54 and Attachments 1-14. SWBT presented extensive data and evidence that clearly demonstrates that the newly-set transport rates (i.e., the interim transport rates) do not recover the legitimate costs to SWBT of serving the low volume transport market areas, which represent a substantial share of the total costs of providing transport service. See SWBT Reply Comments, CC Docket No. 91-213, filed March 19, 1993, pp. 22-35.

investments and expenses which were allocated to interstate transport service by the Commission's Part 36 and Part 69 rules. As shown in SWBT's 1993 Comments, the interim transport rates do not generate sufficient revenue to recover the embedded costs of the facilities necessary to serve the low volume transport market areas, therefore, these costs were incorporated into the Interconnection Charge for recovery. Any recommendations to reduce or eliminate the Interconnection Charge should be evaluated only in the context of the Commission's planned comprehensive review of the access charge rules.

O. LEC Rates Should Not Be Reset For So-called "Bottleneck" Services.

ICG argues that LECs should set wholesale rates for their so-called "bottleneck" services, and that this wholesale rate should be based on long-run incremental cost.[70] ICG goes on to argue that the Commission should require these wholesale rates to be imputed to the LECs' own competing access services.

SWBT strongly disagrees with ICG on these points. As described earlier, no business, including ICG, could survive setting rates at incremental costs. Moreover, ICG incorrectly claims that LEC services are bottlenecks. Alternate supply demonstrates the lack of a "bottleneck." The LECs' competitors provide alternate supply. Further, because the setting of access prices at LRIC results in too low a price, ICG's proposal is wholly incorrect.

P. Operator Call Processing and Call Completion Services Are Competitive and Separate Service Categories Are Not Needed To Restrain Prices.

SWBT has demonstrated that operator call processing and call completion services are competitive and that any additional pricing constraints or regulatory complexities associated

[70] ICG, p. 5.

with these services are unnecessary.[71] While some parties call for the creation of service categories and pricing constraints, such requests should be denied.[72] As evidence of the lack of need for pricing restraints, SWBT has not increased rates for operator call processing services since the service was first tariffed and significant competitive alternatives to 0- transfer services already exist today.[73] Also, realistically, it would not be premature for the Commission to find the LECs to be "nondominant" in the provision of operator call completion services. In any case, it would be inappropriate to impose additional pricing constraints on any of these services.[74]

The Commission should reject any proposal to establish a new operator services service category in the traffic sensitive basket, or in any other basket. As SWBT previously demonstrated, any such proposal would needlessly complicate and restrict the price cap structure at precisely the time that LECs need more pricing flexibility. The Commission is well aware of the competitive nature of the operator services markets.

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[71] SWBT, pp. 43-47.

[72] AT&T, pp. 54-55; MCI, p. 20. MCI is flatly incorrect in its claim that "neither operator services nor call completion services will face significant competition." MCI, p. 20. In fact, the IXCs are the source of much of the competition for these services.

[73] SWBT, pp. 43-45.

[74] SWBT, p. 47.

III. SWBT'S PROPOSAL FOR OBTAINING STREAMLINED AND NONDOMINANT REGULATORY TREATMENT PROVIDES A CONSERVATIVE APPROACH TO DEREGULATION OF PRICE CAP LECS.

As the Commission has noted: "LEC price cap regulation should continue only until competition emerges in the interstate access market."[75] SWBT's proposal is a conservative approach to deregulation of price cap LECs.

A. Under SWBT's Proposal, Price Cap LECs Only Receive Pricing Flexibility Commensurate With The Availability Of Competition In The Marketplace.

Competitors of the price cap LECs insist upon unreasonable measurements of competition and unnecessary safeguards. MCI, for example, argues that the Commission should only grant additional pricing flexibility to LECs if they first lower their access rates to economic costs.[76] CCTA suggests that a firmly established and demonstrated market position, such as the 15% effective competition threshold faced by cable television operators, should be used in determining whether regulation is to be relaxed.[77]

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[75] Second FNPRM, para. 21.

[76] MCI, p. 21.

[77] CCTA, p. 15. NYNEX recommends that the criteria for nondominance (Phase III) be that the LEC has been subject to Phase II treatment for 1 year and competition has not been impeded. NYNEX defines "competition has not been impeded" as a requirement that the competitive LEC (CLEC) market share not diminish and the LEC be unable to raise its prices. It is an improper role of regulation to provide a guarantee of the success of any individual provider. It is particularly inappropriate for regulation to premise regulatory relief on the damage that has been done to a particular provider. The ability of the incumbent provider to raise prices in absolute terms is not the appropriate focus. Market prices in competitive markets can and do rise. If a "no price increase" test were valid, then the recent price increases of AT&T would have been sufficient to deny AT&T nondominant status. The Commission should not use NYNEX's criteria for determining LEC nondominance. Rather, the Commission should utilize a measure of alternative supply availability sufficient to constrain prices coupled with the removal of regulatory barriers to entry as the criteria for nondominance.

These suggestions should be rejected. Instead, the Commission should adopt the measured approach advocated by SWBT in its comments.[78] SWBT has suggested that competition should be examined in determining whether services should be streamlined and in considering a finding of LEC nondominance.[79] Crucial to the proper examination of competition is proper definition of the market so that supply and demand responsiveness can be properly examined. An evaluation of these factors is the proper analysis for purposes of granting streamlined regulation.

B. The Relevant Market As Proposed By SWBT Is Appropriate For The Telecommunications Industry.

AT&T claims that the Second FNPRM's proposal for the definition of a market is inadequate since access purchasers need to acquire all the components of interstate switched access in order to make any switched service available to an end user customer. Thus, AT&T argues, the LECs' market power cannot be assessed by reviewing individual access components

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[78] SWBT, pp. 54-73.

[79] In this docket, SWBT is forwarding a measured approach to allow the Commission to move quickly toward eliminating unnecessary regulation of price cap LECs. Regulation, however, should be changed immediately to recognize that the public interest is not served by applying, to one set of competitors, burdensome and anticompetitive tariff filing rules while relieving another set of competitors from those same rules. SBC Communications, Inc., the parent company of SWBT, has filed for reconsideration of the Nondominant Filing Order on Remand (Tariff Filing Requirements for Nondominant Common Carriers, Order, 78 Rad. Reg. 2d (P&F) 1722 (1995)) to make this point. Given that the Commission currently insists upon applying different sets of rules to different competitors in the same market, SWBT explains in this docket how the Commission should make numerous changes to price cap regulation to alleviate the burdens that these rules create. However, as explained in SBC's petition, action in this docket may remedy some but cannot remedy all the errors cited by SBC in CC Docket No. 93-36.

in isolation.[80] AT&T also recommends that the geographic market should be defined narrowly.[81]

AT&T's comments improperly devalue the competition that exists today for LEC services. Competition cannot be so neatly dismissed. As with AT&T's services, and as found over time by the Commission, certain services were more competitive than others, and were subject to relaxed regulation more quickly. The Commission should not define the service dimension of the relevant market so broadly as to improperly delay relaxed regulation of those discernable access markets that are demonstrably competitive.

SWBT has noted in its Comments[82] how the appropriate product dimension and geographic dimension should be measured in determining the relevant product market. When, as in telecommunications, the supply capacity of firms is not closely correlated with sales, the only reliable market power indicator based on market share is one based on the shares of supply capacity, not on revenue shares.[83] In the current case, the supply capacity shares of the LECs'

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[80] AT&T, pp. 9-10.

[81] AT&T, pp. 12-15; AT&T, p. 14 incorrectly states that "an IXC that purchases transport from a CAP does not have a competitive source of supply to serve an end user located a single block away from the CAP's facilities."

[82] SWBT, pp. 54-64.

[83] E. Thomas Sullivan & Jeffrey L. Harrison, Understanding Antitrust and Its Economic Implications 220-22 (1988); Ball Memorial Hosp., Inc. v. Mutual Hosp. Ins. Inc., 784 F. 2d 1325, 1336 (7th Cir. 1986) ("Market share is just a way of estimating market power, which is the ultimate consideration. When there are better ways to estimate market power, the court should use them. Market share reflects current sales, but today's sales do not always indicate power over sales and price tomorrow (citations omitted)."); Report and Order, In the Matter of Competition in the Interstate Interexchange Marketplace, 6 FCC Rcd. 5880, para. 51 (1991) ("Market share alone is not necessarily a reliable measure of competition, particularly in markets with high supply and demand elasticities."); Metro Mobile CTS, Inc.

(continued...)

competitors by far exceed the revenue market shares of those same competitors. To the extent that the Commission relies at all on any market share data, the calculations must be made using supply capacities in the numerators and denominators.

C. SWBT Has Proposed Appropriate Criteria To Effectively Assess Market Competitiveness.

Several commentors express the position that the Commission need not examine criteria for determination of LEC nondominance because the LECs could never be nondominant, at least not in any foreseeable future timeframe.[84] This position echoes other competitor requests for "stability" and other protectionary measures from the rigors of true competition. Sadly, what is absent from their requests is any mention of how their requests will benefit consumers. The Commission should ignore these requests for protection and move forward with developing the criteria and process needed to determine LEC nondominance on a relevant market area basis.

The proper competitive criteria of demand addressability, as well as the demand responsiveness characteristics utilized for streamlined regulation, should also be applicable for

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[83](...continued)
v. New Vector Communications, Inc., 892 F.2d 62, 63 (9th Cir. 1989) ("Reliance on statistical market share in cases involving regulated industries is at best a tricky enterprise and is downright folly where, as here, the predominant market share is the result of regulation. In such cases, the court should focus directly on the regulated firm's ability to control prices or exclude competition."); Albert L. Danielsen and David R. Kamerschen, "A Methodological Study of Market Power and Market Shares in Intrastate Inter-LATA Telecommunications," in Telecommunications in the Post-Divestiture Era 135, 147-49 (Albert L. Danielsen & David R. Kamerschen eds., 1986); and William Landes and Richard Posner, "Market Power in Antitrust Cases," 94 Harvard Law Review 937, 944-52 (1981).

[84] See, e.g., Ad Hoc, p. 31; TRA, p. 39; Time Warner, p. 61; Sprint, p. 28; and MCI, p. 36.

the determination of nondominance. The only difference is that the threshold of supply responsiveness should reflect an increased intensity of competition in order to justify the additional benefits from a finding of nondominance.

In order to qualify for streamlined regulation in a relevant market, the LEC should demonstrate that customers representing at least 25% of the incumbent LEC's demand in the relevant access services market area have alternate supply available to them. In order to obtain a determination of nondominance in a particular relevant market, customers representing at least 50% of the incumbent LEC's demand within the relevant access services market area should have alternative supply available to them. In addition, regulatory barriers to entry should be eliminated in these areas as demonstrated by full compliance with state requirements to open the local telecommunications markets.

Notwithstanding LECs' competitors' requests for protection through endless regulatory delay, this framework should be established now. Even if some LECs are not able to qualify for nondominance under this approach for some time, construction of an adaptive regulatory framework that recognizes the nondominance of LECs will ensure that there will be a sturdy market structure that can guarantee maximum customer benefit while ensuring equitable treatment for all providers. Given the targeted nature of CAP entry and the significant market presence they have, coupled with the entry of titans such as MCI and AT&T into access and local markets, a declaration of nondominance for several LEC markets may already be overdue.

D. Criteria For Streamlined Treatment and Nondominance Proposed By The LECs' Competitors Are Improper.

AT&T proposes three criteria that should be examined to determine whether LECs face "effective competition." However, AT&T would also only consider these criteria to be

indicators of competition and would allow them to be challenged by other factors that another competitor could raise.[85]

On the contrary, AT&T's criteria (and those offered by other competitors) should be rejected as far too inflexible to properly address the realities of the marketplace. AT&T is again proposing a far more onerous methodology for the LECs than was used for re-examination of AT&T's own price cap services. USTA has noted that many of the criteria proposed by AT&T and others would make it all but impossible for LECs to meet the proposed requirements.

E. Contract Carriage And ICB Pricing Are Legitimate Marketing Tools.

AT&T supports the Commission's proposals to limit individual case basis (ICB) offerings.[86] CompTel argues that LECs should not be permitted to offer ICB rates to their long distance affiliates under any circumstances.[87] MCI also supports the modifications for ICB tariffs and notes that the use of ICB tariffs should be quite rare.[88]

To the contrary, the Commission's rules on ICB tariffs must be relaxed, not made more rigid. The Commission has allowed contract-based pricing for AT&T for years. LEC

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[85] AT&T, pp. 17-18. See Sprint, p. 26; ALTS, p. 14; and Time Warner, pp. 9-10. Compare AT&T's previous simple criteria for assessing market power when AT&T was considered "dominant":

> The ability of competitors to quickly absorb each others traffic should a competitor make a price or service move unacceptable to the market determines whether a firm has market power.

(Ex parte presentation of AT&T in CC Docket Nos. 79-252, 93-197, 80-286, filed February 8, 1995, p. 1.)

[86] AT&T, pp. 31-32.

[87] CompTel, p. 30.

[88] MCI, pp. 14-15.

competitors freely utilize contract-based pricing.[89] GSA does not favor more restrictions.[90] As noted in SWBT's Comments, the Commission should allow ICB and contract-type (individualized) pricing under certain circumstances.[91] This is a minimally reasonable approach when compared to the use of contract-based pricing by the LECs' competitors. In no event are more restrictions reasonable.

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[89] MFS, for example, has over 1,300 separate contract-based service offerings described in its interstate tariffs filed with the Commission.

[90] GSA, pp. 10-11.

[91] SWBT, pp. 24-27.

IV. CONCLUSION

For the foregoing reasons, SWBT respectfully requests that the Commission should adopt a plan for adaptive regulation of price caps as described in SWBT's Comments, and as further explained in these Reply Comments. Such a plan would maximize consumer welfare in the absence of reconsideration of the Nondominant Filing Order on Remand.

Respectfully submitted,

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January 10, 1996

Attachment 1

PARTIES FILING COMMENTS IN RESPONSE TO SECOND FNPRM

1. Ad Hoc Telecommunications Users Committee (Ad Hoc)
2. Ameritech
3. Association for Local Telecommunications Services (ALTS)
4. AT&T
5. Bell Atlantic
6. BellSouth Telecommunications Inc. (BellSouth)
7. California Cable Television Association (CCTA)
8. Cincinnati Bell Telephone Company (CBT)
9. Comcast Corporation (Comcast)
10. Competitive Telecommunications Association (CompTel)
11. Cox Enterprises, Inc. (Cox)
12. General Services Administration (GSA)
13. GTE Service Corporation (GTE)
14. ICG Access Services, Inc. (ICG)
15. Information Industry Association (IIA)
16. LCI International, Inc.
17. LDDS WorldCom (LDDS)
18. MCI Communications Corporation (MCI)
19. MFS Communications Company, Inc. (MFS)
20. National Cable Television Association, Inc. (NCTA)
21. New York State Department of Public Service (NYDPS)
22. NYNEX
23. Pacific Bell & Nevada Bell (Pacific)
24. Southern New England Telephone Company (SNET)
25. Southwestern Bell Telephone Company
26. Sprint Corporation (Sprint)
27. Sprint Telecommunications Venture (STV)
28. Telecommunications Resellers Association (TRA)
29. Teleport Communications Group, Inc. (TCG)
30. The Information Technology and Telecommunications Association (TCA)
31. Time Warner Communications Holdings (TWC)
32. United States Telephone Association (USTA)
33. U S WEST Communications, Inc. (U S WEST)

SWBT Response to "Declaration of Leland L. Johnson, Ph. D.," Attached to Comments of NCTA

NCTA strains the analysis and conclusions of Dr. Leland Johnson beyond their applicability. Johnson, in his declaration, actually supports several of the major policy directions that SWBT consistently has urged the Commission to adopt.

Johnson's basic arguments are that all price cap regimes of which he is aware, or that could be reasonably adopted by regulators, maintain the tie between prices and costs and thus fail to protect against the threat of cross-subsidization. According to Johnson, prices remain tied to costs through the "safety valves" regulators are compelled to adopt, such as the sharing mechanism, including low-end adjustments; frequent formal reviews where past performance is evaluated, including the historic rate of return; the LECs' ability to self-select a new X-factor annually; and through strong public pressure on regulators to revise the price cap formula if profits are persistently high or low.

SWBT agrees with Johnson that these "safety valves" maintain the basic disincentives of traditional rate of return regulation. The remedy, however, is to eliminate these inefficient and unnecessary "safety valve" mechanisms, rather than to continue or increase the regulatory oversight of specific cost assignments. Cost assignments are problematic because they assign joint and common costs to the various services/markets based on arbitrary allocation factors. By their nature, joint and common costs cannot be directly assigned to specific services/markets; any attempt to do so is arbitrary and results in inefficiencies.

The correct solution is to eliminate these unnecessary and economically inefficient "safety valves" to sever all ties between prices and cost allocations. As Strategic Policy

Research showed in their 1994 study, significant efficiency improvements can be realized if earnings sharing and frequent review periods were eliminated from the price cap plan.[1] With USTA's proposal for an automatic mechanized productivity offset calculation and the elimination of ties to cost-plus regulation -- a proposal strongly supported by SWBT -- frequent price cap reviews of any of the financial aspects of the price cap plan are no longer necessary or warranted. The Commission could adopt a relatively long review period of 8-10 years for issues related to financial performance. Adopting such a long review period would help eliminate concerns over gaming of cost allocation because the LECs' overriding concern will be to adapt to the rapidly changing telecommunications markets, and to remain profitable in this new, competitive environment. Cost shifting schemes for reviews 8-10 years in the future will most certainly not be a factor in LEC business decisions. Thus, the Commission can reasonably remove all "safety valves," *i.e.*, any ties between prices and allocated costs from the permanent price cap plan.

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[1] Strategic Policy Research (SPR), *Regulatory Reform for the Information Age: Providing the Vision*, January 11, 1994, at 17-23. SPR estimates the FCC's price cap plan for LECs with sharing and a 4 year review period has approximately 18 percent of the efficiency incentives provided in unregulated competitive markets, just slightly higher than the 14 percent under annual rate of return regulation. By eliminating sharing and adopting a pure price cap plan with a 10 year review period, for example, efficiency incentives relative to unregulated markets increased to 71 percent.

SWBT Response to "Pro-Competitive Pricing Flexibility for Price Cap LECs," by William Page Montgomery, Attachment to Comments of ALTS

Mr. Montgomery argues that the LECs should not be given further downward pricing flexibility because the LECs would use this flexibility to reduce prices as predatory signals warning potential entrants against trying to compete.[1] To keep potential competitors out, the LECs would presumably reduce prices below cost—a necessary condition for predation—once they face the threat of competitive entry. As SWBT, USTA, and other LECs have shown in comments and other filings,[2] the LECs face more than threats of entry; competition exists in many major markets and for most, if not all, LEC access services.

By Montgomery's logic, the LECs would have been engaging in predatory pricing for some time in their unsuccessful effort to keep competitors from entering their markets. But to engage in this supposed predatory behavior, the LECs would have had to reduce their rates by large amounts, and probably would have used up all the downward pricing flexibility they had available under the current price cap system. This did not happen.

The LECs' pricing behavior, in the face of very real actual and potential entry, shows no predatory conduct. In fact, Montgomery argues that:

> to date, price cap LECs have not reduced prices to the extent permitted by the existing FCC rules. Hundreds of millions of dollars in available downward pricing flexibility remain unused at this time by the price cap LECs.[3]

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[1] ALTS, Statement of Page Montgomery (Montgomery), p. 3.

[2] SWBT Comments, pp. 2-3; USTA Comments, pp. 2-7.

[3] Montgomery, p. 2.

In a conflicting turn of logic, Montgomery then uses the fact that the LECs' actual pricing behavior shows no signs of predation as evidence that the LECs do not yet face competitive entry.

Clearly, at- or above-cost pricing cannot be proof that the LECs do not face entry. Nowhere does Montgomery acknowledge the substantial and conclusive evidence on record of actual and real competitive entry into most major LEC markets.

Furthermore, Montgomery agrees that the LECs' interstate access prices contain severe distortions, such as the fixed recovery of non-traffic sensitive costs, and believes that these pricing distortions will at best be only gradually shifted out of interstate prices.[4] This, he concludes, may give the LECs an incentive to price in a predatory manner if they are given unlimited pricing flexibility. This would not happen. The regulatorily-imposed pricing distortions described by Montgomery would make predation even more costly for the LECs. The LECs interstate access rates are relatively high compared to incremental costs because they recover not only incremental and some of the associated common and overhead costs, but also a significant share of nontraffic sensitive costs. If a LEC were to reduce its access prices to just cover marginal costs, a legitimate pricing response that involves absolutely no predation, it would sustain significant losses because it could no longer recover that portion of costs assigned by regulation to the interstate jurisdiction. Thus, even in legitimate pricing, the LEC incurs substantial losses. To engage in predation, a LEC would have to sustain these losses and the additional losses that would result from predation. The LEC has no hopes of recouping any of

[4] Montgomery, p. 9.

these losses in the future, because even if it could cause a competitor to exit the market or delay its entry, re-entry or entry of competitors would occur as soon as the LEC attempted later to raise its access rates.

Montgomery's second reason in support of his predatory pricing argument is simply an assertion that the Commission lacks both the experience and the data needed to assess whether rates cover costs.[5] Considering that rates have historically been set based on cost analyses, it is not clear why the Commission would not have the expertise to evaluate cost studies. In addition, because the Commission's fully distributed costing principles, that were used to establish the price cap LECs' access rates, required substantial loadings of common and overhead costs, the Commission can be confident that interstate access rates cover their incremental costs.

Finally, Montgomery states that the literature on predatory pricing "provide a number of reasons why, as LECs move away from mere pre-competitive pricing of interstate access services, some of them may adopt predatory pricing strategies."[6] Reasoned analysis does not support this conclusion, instead "[t]he evolving consensus among both economists and judges is that aggressive (but entirely legitimate) competition is too often confused with 'predation'"[7]

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[5] Montgomery, p. 10.

[6] Montgomery, p. 11.

[7] Michael K. Kellogg, John Thorne, and Peter W. Huber, *Federal Telecommunications Law* (Little, Brown and Co., 1992), pp. 143-144 (as cited in *Declaration of Leland L. Johnson, Ph.D.*, filed as attachment to Comments of The National Cable Television Association, Inc. , December 11, 1995, pp. 5-6). For a comprehensive treatment of why the prospects for successful predatory pricing are dim, see Frank H. Easterbrook, "Predatory Strategies and Counter-Strategies," *University of Chicago Law Review* (1981), pp. 263-337; and Wesley J.

(continued...)

and as the Supreme Court ruled in 1986, "there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful."[8]

[8] Matsushita Electric Industrial Co. v. Zenith Radio Corp., 106 S.CT. 1348, 1357-1358 (1986).

CERTIFICATE OF SERVICE

I, Katie M. Turner, hereby certify that the foregoing, "Reply Comments of Southwestern Bell Telephone Company" in Docket No. 94-1, has been filed this 16th day of January, 1996 to the Parties of Record.

Katie M. Turner

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January 16, 1996

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