> In the latter half of 1993 we raised some of our prices and fees -- about $500 million on an annual basis. These increases were primarily for services where customer demand is not very sensitive to price.

The maxim that competition drives the prices of products toward economic cost is frequently misunderstood. The notion that competition necessarily drives *all* prices down *to* (rather than simply "toward") economic cost is simply wrong. As Drs. William J. Baumol and J. Gregory Sidak write,

> Economic efficiency requires the price of every product to be set equal to its marginal cost, provided that doing so is consistent with the economic viability of the firm, [but only in] the *absence* of scale economies.
>
> [I]f the firm's production process is subject to economies of scale, then the requirement that prices be set equal to marginal costs is a recipe for bankruptcy. Under economies of scale, the revenues yielded by marginal-cost pricing will necessarily fall short of the total costs of the firm's outputs.
>
> Thus, no regulator can be expected to follow the precept of marginal-cost pricing that is integral to the model of perfect competition, for to do so would either drive the regulated firm into bankruptcy or force government permanently to subsidize the resulting deficit.
>
> More than that, the model of perfect competition [*i.e.*, requiring the price of every product to be set equal to its marginal cost] turns regulation and antitrust toward attempts to populate the industry with a multiplicity of smaller enterprises. But where scale economies are present and substantial, such an effort cannot long succeed unless government virtually dictates all operations of the firms. For otherwise, any one firm that happens to expand will reap a competitive advantage through the scale economies that become available to it, and it will thereby be able to expand even further, all at the expense of its smaller rivals. Thus, where scale economies are substantial an equilibrium with many small firms cannot be expected to last. Nor is it in the social interest that such an equilibrium should endure. For in an equilibrium with scale economies, costs will be unnecessarily high if all enterprises are tiny, since the smallness of the firms must prevent them from taking advantage of the cost savings that scale economies offer. With costs unnecessarily high, prices must be correspondingly excessive if the firm is to survive. That is, the small scale of firms, in equilibrium, can be achieved

> only at the expense of consumers, who must forgo the savings from the scale economies that would have been passed along through lower prices.[15]

Price cap regulation was intended to facilitate *efficient* entry by others, and let LECs prepare for competition themselves, by allowing a limited amount of demand-based pricing (as competitive firms do). Consistent with price caps, our proposal does not expand the amount of demand-based upward pricing flexibility that is currently available to us -- it suggests only an increase in downward pricing flexibility.

Two different types of demand-based pricing seem to excite the particular attentions of our competitors. The first is when two different services recover different margins. Contrary to what our competitors suggest (see, for example, ALTS, Appendix, p. 18), recovering different levels of overhead or other fixed costs from different services is not "discrimination" in either the economic, or the legal sense. The second type of pricing they challenge is when different customers pay different rates for the same service. This, which we refer to as differential pricing, is lawful and pro-competitive under appropriate circumstances.

A. *Recovering Different Margins from Different Services*

The Communications Act prohibits unjust or unreasonable discrimination between the rates paid by customers of the same or "like" services.[16] For reasons that ought to be obvious, the Act does not preclude charging different rates, or recovering different

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[15] *Toward Competition in Local Telephony* (MIT Press, 1994), pp. 33-35 (emphasis added). Dr. Baumol frequently has testified for AT&T, so he can hardly be accused of favoritism toward the LECs.

[16] See *Ad Hoc Telecommunications Users Com. v. FCC,* 680 F.2d 790 (D.C. Cir. 1982), and *MCI Telecommunications Corp. v. FCC*, 842 F.2d 1296 (D.C. Cir. 1988).

levels of profit, from customers of *different* services. Yet this is what some parties suggest the Commission ought to mandate. For example, CompTel complains that "access offerings for which competition is tenable (e.g., DS3 direct-trunked transport) bear a far lower amount of overhead than offerings for which competition does not exist (e.g., DS1, tandem-switched transport), even though these offerings are provisioned over exactly the same physical facilities." (CompTel, pp. 20-21.) LDDS Worldcom complains that "put simply, when LECs charge us a higher share of their overhead than AT&T in access rates, they artificially increase our cost structure." (LDDS Worldcom, p. 13, n.9.) LDDS Worldcom characterizes this as "cross-subsidizing." (*Id.* at 14.)

The notion that recovering different levels of overhead from customers of different services[17] creates a "cross-subsidy" or "keeps retail prices uneconomically high, distorts competition, injures customers, and creates no incentive for the LEC to become more efficient and thereby reduce its overhead," as CompTel alleges (CompTel, p. 18), is badly wrong. The Communications Act prohibits "unjust or unreasonable discrimination ... for or in connection with like communication service."[18] By definition, therefore, a carrier cannot "discriminate" between customers of *unlike* services. Nor can a "cross-subsidy" flow from one profitable service to another profitable service.[19] Pricing different services to yield different margins is not, in itself, illegal or anticompetitive in any sense at all. On the

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[17] Because CompTel argues so often to the contrary, it is worth reminding the Commission of the obvious: services may be un-"like" even if they are sometimes provisioned using the same facilities, as DS1 and DS3 services sometimes are.

[18] 47 U.S.C. Section 202(a).

[19] See below, n.43.

contrary, it is a practice that competitive, multi-product firms *must* engage in to recover their overheads and remain in business.

CompTel, Sprint, and LDDS Worldcom agree that "[t]hese problems will be exacerbated if the BOCs are allowed to offer interLATA long distance services" (LDDS Worldcom, p. 14; CompTel, p. 25. "True competition requires the presence of two or more facilities-based alternative access providers." (Sprint, p. 24).[20] But we advocate relaxing price controls on access services only where competitive alternatives exist; and even there, all access services would continue to be available under price capped tariffs. The suggestion that we would discriminate in favor of our own long-distance provider or impose a "cost-price squeeze" on competitors marks another area where state commissions have already paved the way for the FCC. The CPUC's rules require us to impute to our own competitive operations contributions for the monopoly services that would be purchased by competitors in providing the same service. These rules create a price floor of long-run incremental cost plus lost contribution, ensuring that we could neither price below cost, nor force competitors to increase prices by driving up costs without also driving up costs and prices for our own services. This allows customers to benefit from the economies of a vertically integrated firm, while ensuring the firm's competitors are not "squeezed."[21]

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[20] How Sprint came up with *two* alternative access providers, we are not told. If it reflects a judgment that tacit price collusion might occur if there were only two access providers in the local exchange, experience in long distance suggests that even *three* is not always sufficient.

[21] See *In re Alternative Regulatory Frameworks for Local Exchange Carriers,* D.94-09-065 (September 14, 1994), *mimeo.*

B. *Recovering Different Margins from Customers of the Same Service*

It must be understood that differential pricing to customers *of the same service* (let alone customers of entirely different services) -- that is, recovering different contributions to overheads from different customers -- is not only "one of the most prevalent forms of marketing practices,"[22] but under appropriate circumstances promotes consumer welfare. This is *particularly* true of industries characterized by economies of scale. Drs. Baumol and Sidak give an example which deserves to be quoted in full for this point to be understood.

> It is easy to show that such differential prices, suitably selected, can benefit even the party that pays the higher relative price... [L]et the incremental costs of the first, second, and third units of output [of a hypothetical service] be $100, $80, and $30, respectively. That is, suppose that it costs the firm $100 to supply the first 1,000 messages per month along a given route, an additional $80 to supply the next 1,000 message units, and so forth. Then the firm clearly requires a revenue of $180 to cover the cost of supplying 2,000 message units. So if only that amount is demanded, and there is no differential pricing in the sale of those units, the price must be $90 per 1,000 message units.
>
> Now suppose that a large customer, *A*, offers to purchase an additional 1,000 message minutes along the route, but makes it clear that, because of competition, it can pay no more than $50 for this service. Since the incremental cost of the third 1,000 message minutes is only $30, this is clearly a profitable offer, yielding a net contribution of $20. Assuming that the supplier of telecommunications services earns no more profit than its cost of capital -- which, as always in our discussion, is already included in the cost figures -- the supply of 1,000 message minutes to customer *A* at its $50 offered price must reduce the prices paid by other customers. For the total cost that must now be covered by the firm is $100 plus $80 plus $30, or $210, of which $50 is covered by revenues from customer *A*. This leaves only $160 to be covered by the buyers of the first 2,000 units, so that the price they now have to pay is cut from $90 to $80 per 1,000 units as a result of customer *A*'s bargain purchase under contract. Other customers can save $10 per 1,000

[22] Hal R. Varian, "Price Discrimination," in R. Schmalensee and R.D. Willig, eds., *Handbook of Industrial Organization* (1989), vol. 1, p. 598.

> units because customer *A*'s bargain purchase contributed $20 beyond the incremental cost of serving *A*, notwithstanding its comparatively low price.[23]

While Drs. Baumol and Sidak make the point that "other customers can save" because of one customer's volume purchase, society benefits whether these "other customers" save or not. The moral of the story is that because of differential pricing, resources have been more efficiently used and a surplus has been created where none existed before. The surplus benefits society whether it is returned to other purchasers of the service as a "savings," used to reduce the price of a completely different service, retained as earnings and invested in producing a new service, paid out as dividends to shareholders, paid in taxes and used to provide public services or to reduce the Federal deficit (*i.e.*, to reduce the taxes of future consumers) -- the number of ways the surplus may be used is unlimited.

Our services are generally characterized by marginal costs that are below average costs. Indeed, this is particularly true of the interoffice transport services that are the object of CompTel's complaint. Once a fiber optic strand is laid, it is currently capable of carrying 24,000 simultaneous conversations; experts suggest a future capacity of about 600 million simultaneous conversations.[24] Such a cost structure results naturally in the economies of scale assumed in Drs. Baumol's and Sidak's example. The Commission assumed such a cost structure, for both switching and trunking, when it created zone pricing

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[23] Baumol and Sidak, pp. 73-74.

[24] Michael K. Kellogg, John Thorne, Peter W. Huber, *Federal Telecommunications Law,* 1992, p. 55, n.6. That some DS1 services are provided over copper is beside the point; the market will drive the price and price structure to what the best technology -- fiber -- is capable of providing.

for transport.[25] So did the D.C. Circuit when it reviewed the price caps rules.[26] Experience bears out Drs. Baumol's and Sidak's premise. Competitive industries with a high fixed cost-low marginal cost structure are characterized by ubiquitous differential pricing. Air transportation is one example. As Dr. Harris points out in the Attachment, railroads are another. Resources in these industries are undoubtedly better utilized today than when they were fully price-controlled and prices were based on average costs. Since they were deregulated, average, inflation-adjusted prices have fallen.

In the long distance business, too, average prices per minute are said to have fallen as discounting has become more widespread. The Commission itself has appeared to suggest there is a connection between these two events.[27] There is no reason to believe that discounting could be any less beneficial to access customers. Indeed, having been taught by our competitors that discounts are available, customers will learn to demand them. As Drs. Baumol and Sidak write:

> [I]n telecommunications as in rail transportation, increased flexibility in regulation has led to more intensive bargaining between suppliers and their largest customers. This bargaining process has yielded contracts with attractive terms for the buyers. Most of these big customers are business firms, many of which compete directly with one another. If one succeeds in eliciting low telecommunications prices from its suppliers, other large customers are forced to demand similar treatment. The result is not only that buyers naturally desire special pricing terms; rather, they are *forced* to demand such prices. If they do not get them, they will find themselves at a marked competitive disadvantage.[28]

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[25] See *In the Matter of Expanded Interconnection with Local Telephone Companies,* 7 FCC Rcd 7369, para. 179, n.415.

[26] See *National Rural Telecom Ass'n v. FCC,* 988 F.2d 175 (D.C. Cir. 1993).

[27] *Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier,* Order, FCC 95-427, released October 23, 1995, paras. 76-78.

[28] Baumol and Sidak, p. 73 (emphasis in original).

Where carrier-initiated rates are concerned, there is one type of differential price that is always just and reasonable. It is a price that encourages the consumption of a service with declining marginal costs. This is, in effect, the basis on which the Commission has found AT&T's discounts and promotions to be lawful.[29]

C. *Recovering No Margin At All from Competitors*

A requirement to sell all "inputs" to long distance service at cost (MCI, p. 5) would be unprecedented and makes no sense whatsoever. Though facilities-based competition in the interexchange market was slow to develop, AT&T was never subject to any requirement to offer facilities to competitors at cost. Nor should it have been. For reasons given by Dr. Harris (Attachment B, pp. 55-58), such an approach would serve no legitimate economic purpose and would be potentially confiscatory. Indeed, if we had to sell service to MCI at cost, there would be nothing to prevent MCI or other access providers from simply reselling it at a profit and keeping the markup for themselves.

VI. Competition and the Local Exchange "Bottleneck"

Various competitors contend that LECs will continue to maintain control over "bottleneck" facilities, that this will inhibit the development of further access competition, and that as long as the LECs have such a "bottleneck" no further pricing flexibility should be allowed for access services. (See, for example, Cox, pp. 3-4.)

The Commission itself has expressed concern. It has suggested that:

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[29] See *Policy and Rules Concerning Rates for Dominant Carriers,* CC Docket No. 87-313, Revisions to Price Cap Rules for AT&T, 93-197, Further Notice of Proposed Rulemaking, 10 FCC Rcd. 7854 (1995), para. 62.

> The institutional structure of the industry itself may operate in combination with our access charge rate structure to contribute to suboptimal pricing. This is because the end user generally selects the local service provider, to the extent there is any selection to be made, even though the IXC is responsible for compensating the local service provider for much of the cost of access. Furthermore, an IXC terminating a call has no choice regarding the local service provider whose facilities will be used for that purpose.[30]

This might once have been an important issue, but in our case, it is moot. First, in California, it will presently be resolved by loop unbundling, rules for mutual compensation, and full-fledged competition. Second, even if California regulators had taken none of these steps, under Pacific's proposal for nondiscriminatory, contract-based pricing in competitive areas, it would still be moot. Interstate terminating access will still be available from a general tariff, at prices determined by the price cap formula.

In California, loops will be unbundled as soon as our agreement with MFS is approved. Any other competitor may take advantage of the MFS agreement and buy unbundled loops from us on the same terms; negotiate its own agreement; or wait for a tariffed option. This spring the CPUC intends to adopt comprehensive rules for all providers who wish to buy unbundled loops and resolve such issues as number portability, access to databases and directory assistance, and mutual compensation.

In a market with unbundled loops and multiple "local service providers," market power -- if any -- does not necessarily inure to today's LEC. In his recent testimony to the CPUC, Dr. Harris testified to the applicability of the "bottleneck" and "essential

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[30] *Second Notice*, para. 27.

facilities" doctrines to the local loop.[31] As Dr. Harris points out, there is a bottleneck in local exchange service -- but it is independent of the number of loops. The bottleneck arises "not from there being a monopoly supplier of local exchange services in the area but from the fact that each customer is served at any given time by only one carrier." (Attachment B, p. 54.) For reasons we pointed out in our Comments, the loop is not an essential facility in itself. (Comments, pp. 35-36.) There is "only one element of local exchange service which is unquestionably an essential facility -- the ability to terminate calls on a competitor's network." (Attachment B, p. 56.)

With unbundling and full certification, there will be no distinction between local service providers, long distance providers, and others.[32] Sixty-nine different providers have now been certified, or applied for certification as local exchange carriers in California. Thirty-nine of these have stated they will use their own facilities. All, however, will be eligible to buy an unbundled loop from us. This will enable all of our competitors to offer exchange access, carrier access, long distance, wireless, video, and information services. As we noted in our Comments, there will be intense competitive pressure to provide a full array

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[31] Though the Commission has suggested that a "bottleneck" and an "essential facility" are one and the same -- see *Policy and Rules Concerning Rates for Competitive Common Carrier Services,* 85 F.C.C.2d 1, 21 (1985) -- Dr. Harris notes that this is untrue. The difference is an important one. See Attachment B, pp. 53-57.

[32] These entire Reply Comments assume that we will be permitted to offer interLATA services. If we are not allowed to do so, none of the issues discussed here would be issues at all. And *until* we are allowed to do so on the same terms as competing IXCs, we will be seriously disadvantaged competing for customers.

of end-to-end services to customers: witness AT&T's restructuring (Comments, p. 14) and its pricing strategies.[33]

The regulatory climate is not the only distinctive thing about California. In the degree of competition that will develop here, we simply bear no resemblance to the rest of the nation. In our Comments we noted the richness and concentration of our access markets.[34] Equally important is that one-third of the nation's intraLATA toll calls occur here. California regulators have kept basic rates low in part by keeping these intraLATA toll rates high. Due to our switched access rates, which are now among the lowest in the country, the difference between the cost and the price of intraLATA toll calls is higher in

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[33] AT&T has "imposed a 40-cent surcharge on all interstate 'dial around' calls using the '10288' access code that are made by customers who have not selected AT&T as their presubscribed interexchange carrier, a company spokesman said." *Telecommunications Reports,* December 11, 1995, p. 20. Customers who use AT&T for *all* of their services are also rewarded with bigger discounts; we can't offer discounts on cellular calls or long distance calls, because we don't carry them.

[34] The number of collocation arrangements continues to grow: there are now eighty-four operational cages in fifty offices, with another twelve cages ordered in seven additional offices. From these fifty offices, collocators have access to two-thirds of our total access traffic. Even more striking, however, is how tightly focused collocators are on the densest wire centers of all. Twenty-five percent of all collocation cross-connects are located in just one office: Los Angeles 01. Fifty percent are in four other offices. In the top ten offices with the most collocation cross-connects, the cross-connects ordered would carry more than twice the amount of switched access traffic in those offices.

California than anyplace else that we know of.[35] The margin in California intraLATA toll calls has attracted so much "incidental" intraLATA bypass that, by Dr. Harris's estimate, Pacific Bell's share of the California intraLATA toll market is less than AT&T's share of the domestic long distance market. Dr. Harris estimates that Pacific Bell now carries only 56% of intraLATA minutes in California, and only 14% of combined intraLATA and interLATA minutes. (Attachment B, p. 22.) Providing local service enables competitors to gain complete customer control.

Investor's Business Daily reports:

> California is shaping up to be a proving ground for the cable industry's push into the $90 billion local phone market. The upcoming battle pits Pacific Telesis Group, which provides local phone service to California and Nevada, against cable giants Tele-Communications Inc. and Cox Communications Inc.
>
> TCI and Cox have invested huge sums to upgrade their cable networks in San Francisco and San Diego, respectively. Both plan to start offering two-way voice and data service next year. The plans assume regulatory barriers to local phone competition are removed, as is expected by early 1996. The fight is likely to start in San Francisco, says Dan McCarthy, division vice president of TCI Cablevision of California. "It's a high-priority market for us," he said. "The demographics are great for doing business, and the regulatory environment in California is improving vastly."

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[35] IntraLATA toll competition began in California on January 1, 1995. We immediately reduced our average switched access charge by more than 50%. For a four minute, 80 mile call, our average access rate for originating and terminating the call fell from $.23 to $.11 (rounded to the nearest cent). AT&T, whose cost of carrying this call thus fell by twelve cents, passed along a one cent reduction to the caller who pays its interLATA basic rate. The CPUC's Division of Ratepayer Advocates responded: "only the IECs and their shareholders will be receiving the full benefits of the switched access charge reductions, and not ratepayers who use interLATA services ... the IECs appear to be leveraging their market power in the interLATA market to sustain lower rates in the intraLATA market." Letter from Jeffrey P. O'Donnell, Division of Ratepayer Advocates, to Jack Lentza, Chief, Telecommunications Branch, CPUC, December 21, 1994.

> "San Francisco will be one of the first battles between two industry titans that are very focused," agreed Bill Geppert, vice president and general manager of Cox in San Diego. "But we're very committed to San Diego. It's our top priority."
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> "It's the strength of alliances that will matter in the end," said Peter Krasilovsky, a senior analyst at Arlen Communications Inc., a market research firm. "I don't think the phone companies are all that afraid of cable invading their turf, but they are scared of their alliances with long-distance firms."
>
> Cox and TCI already have teamed up with Sprint Corp. and cable firm Comcast Corp. The joint venture was the top bidder for spectrum rights auctioned off by the Federal Communications Commission for a new wireless phone technology called personal communications services, or PCS. The venture will allow the cable firms to provide long-distance service along with local phone service. And with the Sprint name behind them, Cox and TCI might overcome consumer fears about phone service quality.[36]

In two of our top three markets, Cox and TCI will therefore compete with us not only to offer exchange access, but carrier access, long distance, video, and wireless. If they buy loops from us, they will control the customer. If they don't like the price that MFS has already agreed to pay for our unbundled loops, or the price the CPUC sets, and cannot negotiate a better price with us, they will use their own loops. As Dr. Harris reports, a recent study estimated the costs of upgrading cable plant to provide telephony (assuming the cable company has upgraded its backbone transmission plant to fiber) would be about $207 per subscriber -- little more than a year and a half's worth of basic exchange rates in California. TCI has reportedly spent $500 million on its fiber network in the San Francisco Bay area and is installing switches and amplifiers needed for 2-way transmission. (Attachment B, pp. 36-37.)

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[36] "A New Cable-Phone War Draws Near in California," Brian Deagon, Dec. 20, 1995, p. A6.

In a market with so many "local service providers," the issue of market power over terminating access is an issue of *mutual compensation.* Every provider will need to terminate calls to other providers. As one vice-president of AT&T acknowledged, the company "will have to have alliances of some sort with the companies that provide the last-mile access to the home."[37] As evidenced in Attachment C, MFS and Pacific Bell have already agreed on the terms of such compensation.

The long-term scenario suggests cooperation, not exploitation. Providers will need one another.[38] In Britain, there is no interconnection tariff; no requirement for BTI to unbundle its loops; only a duty to negotiate with the new carrier. (BTI offers interconnection at its fully allocated cost.) Yet when it sought permission from the Department of Justice to buy twenty percent of MCI, BTI described Britain as the most competitive telecom market in the world.

The terms of carrier access to local loops, like the terms of customer access to local loops (deposits, disconnection, and so forth), are local issues properly addressed before local regulators. California is already affirmatively dealing with the issues. To the degree

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[37] *San Francisco Chronicle,* June 7, 1993, at E7.

[38] If the loop conferred the kind of market power that IXCs claim it does, IXCs ought to be lining up to buy unbundled loops at almost any price. Unlike us, they can charge whatever the market would bear for terminating access. But that isn't happening. They have expressed an interest only in buying loops at today's below-cost retail price, a price originally set by state regulators, with assistance (through the separations process) from this Commission, to subsidize end user access. See, for example, Ad Hoc, pp. 23-34. This gives them "the first shot at obtaining the business that is priced far above cost ... an equal shot at the overpriced markets without having to bear any of the costs that justify that overpricing." Alfred E. Kahn, "A Free Ticket to Rich Telecom Markets," Wall St. J., November 10, 1995, p. A15.

there is an overriding national interest in having uniform nationwide rules, Congress seems fully prepared to deal with it in pending legislation.[39]

Contrary to what LDDS WorldCom argues, structural separations in particular are economically unjustified, as the Commission itself has recognized. "While structural separation decreases opportunities for cost-shifting and anticompetitive conduct, it can also decrease efficiency and affect the interexchange carrier's ability to compete.... To the extent there may be efficiencies within [carriers'] structures they should not be precluded from capitalizing on them where countervailing regulatory considerations do not demand stringent separation."[40] Structural separation means higher prices to consumers, a "direct monetary cost"[41] that should not be imposed on society unless there is certain to be a substantial benefit.

We mention last -- because the Commission must already know it -- the most important point of all. Pacific's proposal for nondiscriminatory contract-based pricing moots the issue of market power over terminating access, even if we were the *only* provider. Under our proposal, our competitors would have a choice of not one but at least two arrangements for terminating access. The first choice is to take access service under a contract. Clearly, for providers who qualify, the contract price will be less than the tariff price. There will be no limits on resale. Nondiscriminatory contracts will extend to all qualifying providers the equivalent of "most favored nation" status. The second choice is to

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[39] See for example S. 652 (104th Cong., 1st sess.), Part II.

[40] *Second Computer Inquiry,* 77 F.C.C.2d 384, 476 (1980).

[41] *Computer III Remand Proceedings,* 6 FCC Rcd. 7571, para. 8 (1991).

take service under the tariff. The terms in our interstate tariffs which will continue to be generally available to all customers throughout our area and will be subject to price cap regulation.

VII. Cross-Subsidies

Some competitors allege that if we had increased pricing flexibility, we would cross-subsidize more competitive services with the revenues from less competitive services. (See, *e.g.*, NCTA, pp. 6-9.) (We note the cable industry seems unconcerned about the possibility that it might cross-subsidize its telecommunications forays with revenues from rate of return-regulated cable monopolies.)

A product or service is cross-subsidized if and only if it is offered below its incremental cost.[42] Both state regulators and the FCC regulate cost allocations to preclude cross-subsidies. Indeed, these regulations are based not on incremental costs but on fully distributed costing, which routinely errs on the side of *overallocating* costs to unregulated ventures. Both the FCC and the CPUC routinely and aggressively audit Pacific's books; independent auditors review them; automated reporting systems like ARMIS are used to cross-check our allocations; and we file dozens of reports with both commissions designed to guard against cross-subsidies.

Time and again since 1991 this Commission has rejected arguments that its cost accounting rules are inadequate to guard against cross-subsidies. For example:

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[42] See, for example, Baumol and Sidak, p. 81; William J. Baumol et al., *Contestable Markets and the Theory of Industry Structure* (rev. ed. 1988), pp. 352-353; Daniel F. Spulber, "Deregulating Telecommunications," Yale J. on Regulation, vol. 12, no. 25 (1995), p. 58.

> We reject claims that we should amend Part 64 because current rules would not prevent LECs from improperly subsidizing video dialtone nonregulated services. To the contrary, we conclude that existing Part 64 rules do not require modification to prevent such an outcome.[43]

NCTA argues that price caps will not deter cross-subsidies, as the Commission believes, because it fails to break the link between costs and prices. (For this proposition, NCTA asserts support from Prof. Kahn.) It is one thing to suggest, as Prof. Kahn has done, that price cap regulation does not completely eliminate the tendency of regulators to regulate. It is quite another thing -- and highly implausible -- to suggest that a LEC would pursue a strategy of losing hundreds of millions of dollars in a market (though somehow concealing these losses from regulators) on the assumption that at some future time it could cover its losses by manipulating its productivity data and persuading regulators to grant an undeserved rate increase.

Specifically, NCTA suggests that by misallocating costs from video or unregulated ventures to regulated telephony, a LEC could influence the Commission's choice of productivity factor in a future review of price caps, or perhaps apply for a rate increase on the basis that its earnings have reached confiscatory levels. The first problem

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[43] *Telephone Company-Cable Television Cross-Ownership Rules,* CC Docket No. 87-266, RM-8221, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244 (1994) para. 179. See also *Computer III Remand Proceedings* CC Docket 90-623, Report and Order, 6 FCC Rcd 7571 (1991); *Telephone Company-Cable Television Cross-Ownership Rules,* 10 FCC Rcd 7887 (1995), para. 10 ("our current video dialtone rules contain provisions intended to ensure that telephone companies providing video programming directly to subscribers do not discriminate in favor of their affiliated programmers and do not subsidize video programming operations with rates collected from their provision of monopoly telephone service"); *Telephone Company-Cable Television Cross-Ownership Rules*, CC Docket No. 87-266, Fourth Further Notice of Proposed Rulemaking, 10 FCC Rcd 4617 (1995), para. 34.

with the argument is that it ignores the cost allocation process, or assumes that it is completely ineffectual. The second problem is that it seems to assume continued sharing ("the situation is different with a regulated firm that is unable to engage in profit maximization," NCTA, p. 3), when most price cap LECs have not elected sharing and the Commission seems disposed to eliminate the sharing option.[44] In addition, total factor productivity, which the Commission has tentatively endorsed and which the LECs themselves advocate, examines the productivity of the total enterprise, not just the regulated part of it.[45] A shift in costs from unregulated to regulated ventures would not change a company's TFP. Even if TFP were not adopted, NCTA's productivity-gaming scenario would still not be plausible. The Commission consistently has examined *industry-wide* productivity, not just the productivity of one company.[46]

Even if such a rate increase were granted, this strategy would make no sense. As Prof. Daniel Spulber writes, it would be "inconsistent with business objectives and economic analysis to expect that an RBOC would enter a market with the intention of incurring a loss, even if that loss were subsidized from earnings in another part of its business. The interests of the RBOC's owners would be to invest those earnings in a venture expected to be profitable.... A business will not cross-subsidize a new business venture that it expects to be unprofitable."[47]

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[44] *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, FCC 95-406 (released September 27, 1995), paras. 8, 9.

[45] *Id.* at para. 9.

[46] *Id.*

[47] Daniel F. Spulber, *Deregulating Telecommunications*, Yale J. on Reg., vol. 12, no. 25 (1995), p. 60.

VIII. Checklists and "Barriers to Entry"

Various competitors contend that none of the very limited reforms of price cap regulation that the Commission has proposed should be allowed until "the removal of barriers to competitive entry." (ALTS, pp. 2-3; Ad Hoc, p. 20; Time-Warner, p. 29.) There is no connection between price cap regulation and competition. Price cap regulation was intended to "mirror the efficiency incentives found in competitive markets," not to apply "to a carrier or industry that faces substantial competition."[48] The reason is simple. If competition exists, then neither the price ceilings, nor the price floors (which in most cases are far above LRIC) of FCC price cap regulation will promote the welfare of consumers. Price *reductions* should be presumed to promote competition; and as Prof. Kahn and Dr. Tardiff said in their report, the "removal of all price *ceilings* ... is the first and most logical implication of a finding that competition is effective." (Kahn-Tardiff Report, p. 11 (emphasis in original).)

For reasons we have pointed out in our Comments (pp. 33-35), there are, in economic terms, no barriers to entry in the local exchange anymore. Most of the "checklist" items advocated by our competitors do not concern competitive *barriers to entry* at all. They concern entry *costs* or competitive *advantages.* To an economist, a "barrier" is either a legal ban on competition, or an entry cost that is so high, relative to the profit opportunity of entry, as to be prohibitive. The distinction the Commission draws between "endogenous" and "exogenous" barriers to entry (*Second Notice,* para. 22) is not invalid. But in the wrong

[48] Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, para. 33 (1990).

hands it may be misunderstood, since nearly all cost advantages that one firm has over its rivals are "endogenous" (*e.g.*, doing more with less; better systems or management; vertical integration), and may even, without much thought, seem unfair (*e.g.*, owning the real estate underneath the store). In California, where such issues as loop unbundling, mutual compensation, and other frequently mentioned "checklist" items will be resolved early in 1996, what carriers will have the greatest number of cost or competitive advantages is still unclear.

Brand equity, for example, is an important competitive advantage -- for AT&T. AT&T has one of the best-known brand names in the world. It spent nearly $700M on advertising in 1994, the most of any brand.[49] When the name of McCaw paging service was changed to AT&T, the number of customers inquiring about the service increased tenfold from 600 to 6000 per week.[50]

Cash flow is another advantage that does not always accrue to us. Cash flow is to competition what reserves are to warfare. It is what enables businesses to embark on major new initiatives and respond to major new challenges. As AT&T Chairman Robert E. Allen said to explain AT&T's recent restructuring, "to the extent we can get in trim, we'll produce better margins, more flexibility and more cash flow to invest in other opportunities.... We've radically changed the focus and cost structure of the new AT&T ... to

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[49] R. Craig Endicott, "Top 200 mega-brands by 1994 ad spending," *Advertising Age*, May 1, 1995, p. 34.

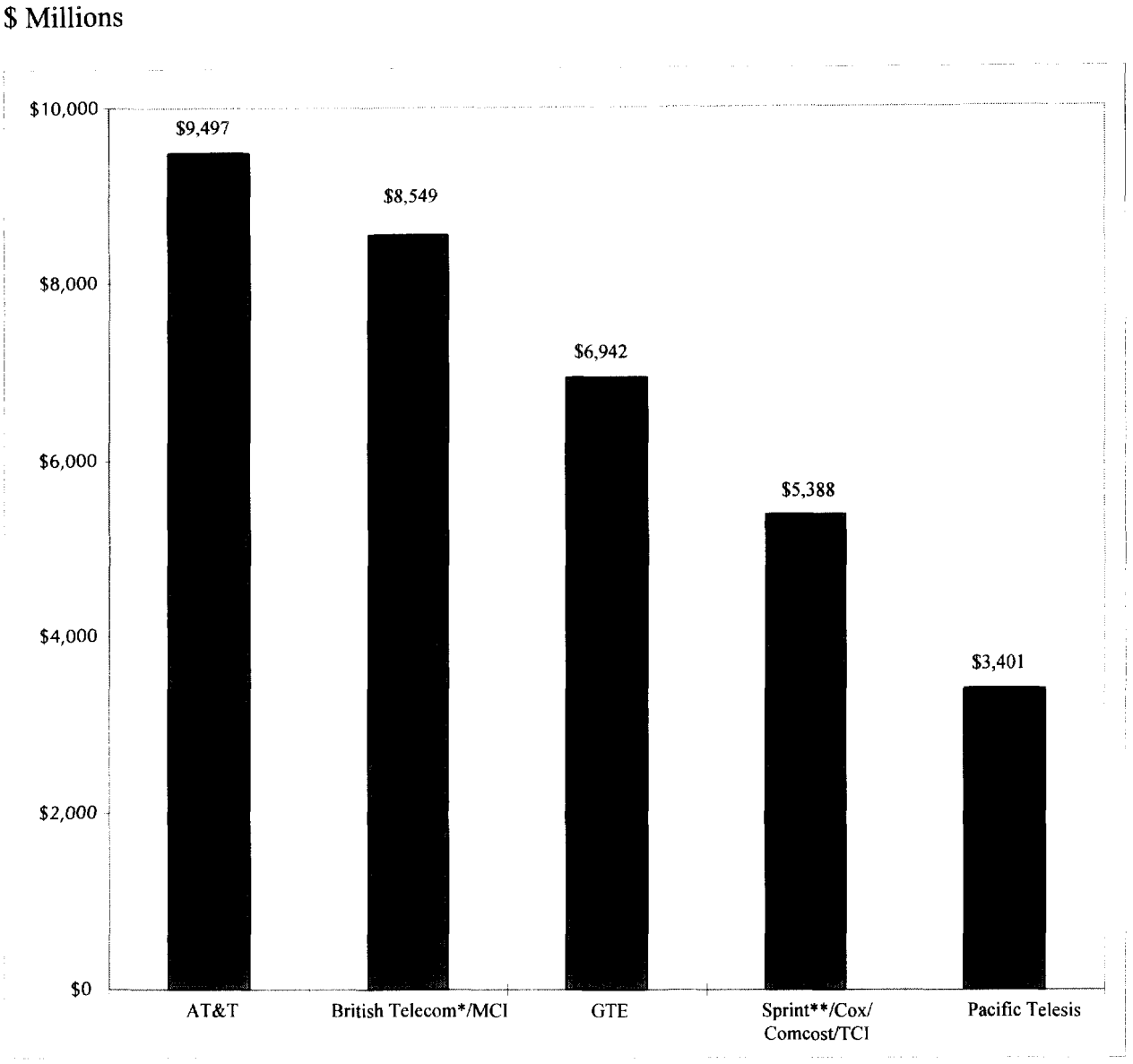
[50] John J. Keller, "AT&T Eagerly Plots A Strategy to Gobble Local Phone Business," Wall St. J., August 21, 1995, p. A1.

defend our markets and attack others."[51] But there was nothing sickly about AT&T's cash flow before. In its 1994 Annual Report, AT&T's Chairman pointed out that its revenue *growth* of $5.7B in 1994 "exceeded the *annual revenues* of 80 percent of the companies in the 1994 *Fortune 500* listing." AT&T is not the only carrier that dwarfs us in this respect, as the following table shows.

[51] John J. Keller, "AT&T Will Eliminate 40,000 Jobs and Take a Charge of $4 Billion," Wall St. J., January 3, 1996, p. A3. For AT&T's healthy margins, see n.8 above.

FIGURE 2

1994 Operating Cash Flows of Major Telecom Providers



*Figures for BT have been converted form £ to $ using a 1.49 rate and follow UK GAAP conventions.
** Excludes France Telecom and Deutsche Telecom.
Source: Company annual reports.

The capability to offer all telecommunications services (a form of vertical integration) is yet another competitive advantage that we do not currently have. On January 1, 1996, dozens of IXCs were certificated to provide all telecommunications services in California, but we are not be allowed to provide interLATA. Even if we could offer a full array of services simultaneously with IXCs, market research suggests that AT&T will gain more from such a free-for-all than any other carrier, with RBOCs the big losers. For example, a Morgan Stanley report projects that only 15% of residential long distance customers would sign up with RBOCs, but 30% of local service customers would switch to AT&T (all RBOCs would be left with just 35%).[52] If this seems surprising, we remind the Commission of the substantial number of consumers who think AT&T still *owns* the BOCs. A majority of AT&T's customers have never changed carriers. Through good times and bad, they have *always* been signed up with AT&T.

Some commenters (such as Cox, p. 4) contend that loss of market share should determine the timing and degree of pricing flexibility. Market share is neither a barrier to entry, nor a good indication of competition. And as the Commission sensibly observed in CC Docket No. 91-141, "[w]e reject proposals to delay any competitive rate changes by the LECs ... until after they have lost a specified proportion of market share. A threshold based on a simple percentage share of market penetration by LEC competitors comes too close to allocating market shares among competitors. We do not intend to try to

[52] Morgan Stanley, "Telecommunications Services: Customer Preference Survey: Results Say Jump Ball!", July 13, 1995.

determine competitive outcomes."[53] But an even better way to characterize the effect of a market share test would be an allocation of *markets*, not just market share -- since competitors will concentrate on the markets where rates are farthest above costs.

The difference between barriers to entry and competitive advantages is important. Reducing barriers to entry -- as Congress and state Commissions and legislatures are now doing -- promotes competition. But trying to "level the playing field" so that no carrier has an advantage over any other may only hinder competition. Competitive advantages, like the hundreds of millions of dollars that AT&T sinks into advertising to maintain its brand equity -- or analagously, the network we have already built -- are what enable efficient providers to win customers. Not every cost that competitors must bear, but we don't, is a barrier to entry. And for every cost that we must bear, there is one that our competitors don't.

The "checklist" approach invites endless tinkering, lobbying, and manipulation that ill-uses the Commission. Attempting to balance competitive advantages would result not in a more vibrant marketplace but, as the Court of Appeals for the Seventh Circuit remarked colorfully, in "unprincipled compromises of Rube Goldberg complexity among contending interest groups viewed merely as clamoring supplicants who have somehow to be conciliated."[54]

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[53] *In the Matter of Expanded Interconnection with Local Telephone Company Facilities*, CC Docket No. 91-141, Memorandum Opinion and Order, 9 FCC Rcd 5154 (1994), para. 156.

[54] *Schurz Communications v. FCC*, 982 F.2d 1043, 1050 (7th Cir. 1992).

IX. Conclusion

For reasons set out above, we urge the Commission to adopt the proposal we presented in our Comments.

Respectfully submitted,

PACIFIC BELL
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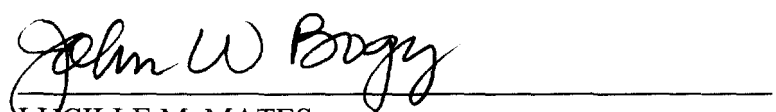

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