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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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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
Revisions to Price Cap Rules for AT&T	CC Docket No. 93-197

REPLY COMMENTS OF AT&T CORP.

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February 6, 1996

TABLE OF CONTENTS

Page

SUMMARY iv

I. THE CLEAREST PROOF OF THE NEED FOR CONTINUED PRICE REGULATION OF ACCESS SERVICES COMES FROM THE COMMENTS OF END USER CUSTOMERS AND LEC AFFILIATES THAT ARE SUBJECT TO THE POWER OF MONOPOLY ACCESS PROVIDERS IN OTHER MARKETS. 2

II. MARKET DEFINITION ISSUES 12

A. It May Be Appropriate To Use Wire Centers To Define Geographic Markets 13

B. Product Market Definition 16

1. Access Elements Are Interrelated And Cannot Be Viewed In Isolation 16

2. The Commission Should Use The Existing Price Cap Categories, But LECs Should Be Allowed To Propose Alternative Product Markets 18

3. Product Markets Should Not Be Defined Based On A Switched/Special Access Dichotomy Or On The Identity Of End User Customers 19

III. ISSUES RELATING TO ASSESSMENT OF MARKET POWER 20

A. Supply Elasticity 21

1. The Commission Should Only Review Facilities-Based Competition In Determining Supply Elasticity 21

2. The LECs' Addressability Tests Are Inconsistent With Prior Commission Actions And Inadequate To Prove The Existence of Substantial Competition 25

B. Many LECs Improperly Assume Away The Importance Of Demand Responsiveness 29

TABLE OF CONTENTS
(continued)

Page

C. The LECs' Huge Market Shares Cannot Be Ignored In Assessing Their Market Power 32

D. Other Issues 35

1. Checklists Are Helpful Tools For Determining Whether The Preconditions For Effective Competition Are Met 35

2. The Commission Should Not Rely On State Rules To Determine Whether There Is Effective Competition 36

3. A Notice And Comment Procedure Should Apply To All Requests For Reduced Regulation 38

IV. LEC PRICE CAP REGULATION SHOULD NOT BE RELAXED IN MERE ANTICIPATION OF THE EMERGENCE OF COMPETITION IN THE ACCESS AND LOCAL EXCHANGE MARKETS 39

A. The Current Cost Support And Notice Requirements For New Services And Restructures Should Be Retained 40

B. The Part 69 Waiver Process Should Not Be Relaxed 43

C. The Proposals For Individual Case Basis Offerings Should Be Adopted To Codify Existing Policy 47

D. The LECs Should Not Be Permitted To Respond To Requests For Proposals On A Contract Tariff Basis 49

E. Lower Service Band Limits Should Be Eliminated, Provided Safeguards Against Cross-Subsidization And Predatory Pricing Are Imposed 52

F. Zone Pricing Should Not Be Extended To Additional Rate Elements 56

TABLE OF CONTENTS
(continued)

Page

G. The Price Cap Baskets And Service Categories Should Not Be Revised At This Time 60

H. New Service Bands For Operator Services, LIDB and Operator Call Completion Services Should Be Created In The Traffic Sensitive Basket 68

CONCLUSION 71

APPENDICES

APPENDIX A: List of Commenters

APPENDIX B: Comments of BellSouth Europe to the European Commission's Green Paper on the Liberalisation of Telecommunications Infrastructure and Cable Television Networks, filed March 15, 1995

APPENDIX C: "Regulation of Access to Vertically-Integrated Natural Monopolies, A Discussion Paper," submitted by BellSouth New Zealand to the New Zealand Government, dated September 1995

APPENDIX D: "A Framework for Effective Competition, A Response to OFTEL's Consultative Document," submitted by U S WEST International to the UK Office of Telecommunications, March 30, 1995

APPENDIX E: A 25% Addressability Standard Does Not Significantly Limit A LEC's Ability To Increase Prices

APPENDIX F: Impact Of 1% Upper Service Band Limit On LEC Pricing Flexibility

SUMMARY

Because the LECs retain near-total market power in the local exchange and access markets, the comments support the Common Carrier Bureau's recent determination that competition in these markets is more than a decade behind competition in the interexchange market. Thus, as described in Section I below, the comments confirm that it is critical for the Commission to retain price regulation of access services, and that nascent competition in small segments of the local markets does not require or warrant any major changes in price cap regulation at this time. The comments also show that the Commission should focus its attention on reforming access charges so that they are at direct economic cost and nondiscriminatory, and on assuring that other preconditions for effective local exchange and access competition are established.

The non-LEC commenters are unanimous in their view that streamlining (and *a fortiori* nondominance) for any access service is premature. Nevertheless, Section II discusses the geographic and product market issues the Commission will have to face when (and if) effective competition develops. In particular, AT&T agrees with the recommendation that LEC wire centers (or groups of contiguous wire centers) may be appropriate geographic markets, provided that AT&T's metrics for measuring competition are applied and that LECs are required to average access prices across entire markets.

With respect to product markets, AT&T notes that most commenters have ignored a key distinction made by the Commission, which recognizes that access "services" are in fact only components of overall access. Accordingly, the Commission must take this fact into account as it reviews requests for reduced regulation of access "bundles." AT&T also supports the views of numerous commenters that the Commission should initially use the existing price cap baskets and categories as product markets. LECs may, however, be allowed flexibility in individual cases to propose other product markets based on market conditions. The Commission should not, however, create separate product markets for switched and special access, nor should it create product markets based solely on the identity of access customers' end users.

Section III replies to comments regarding the Commission's assessment of market power, particularly issues associated with supply elasticity, demand responsiveness and market share. Section III.A shows that most commenters, including LECs, agree that the Commission should focus primarily on facilities-based competition in determining supply elasticity. Thus, the Commission should reject Bell Atlantic's claim that resale competition may be sufficient. This section also shows that the LECs' proposed 25% "addressability" test for streamlining is insufficient under Commission precedents and completely inadequate to restrain LECs' market power.

Section III.B demonstrates that, contrary to some LECs' arguments, demand responsiveness is a critical factor that cannot be assumed away based on theoretical arguments. Similarly, Section III.C refutes the LECs' claims that their huge market share is irrelevant in determining their market power and shows that these claims are also contrary to the Commission's prior practice. Section III.D supports the use of checklists to help establish the existence of effective preconditions for competition, urges the Commission to create and rely upon federal (rather than state-developed) standards for determining when interstate access markets are competitive, and agrees with most commenters that notice and comment proceedings should be used to review LEC requests for reduced regulation.

Section IV shows that the Commission should not adopt most of its proposed price cap and procedural changes (or the additional ones suggested by LECs) as part of baseline regulation because they would provide the LECs unwarranted and undue flexibility that could result in increased rates and discriminatory strategic pricing. In particular, as shown in IV.A, the comments confirm that the current cost support and notice requirements should be retained to permit interested parties to scrutinize new services to ensure rates are not set at monopolistic or discriminatory levels. Section IV.B then demonstrates that rather than revising the Part 69 waiver process, the

Commission should proceed with fundamental access reform and, in the interim, act promptly on filed waivers.

The non-LEC commenters also broadly support the Commission's proposal to maintain existing requirements for individual case basis filings, which correctly recognizes that instances of ICB pricing in noncompetitive markets should be strictly limited (see Section IV.C). Moreover, as shown in Section IV.D, the Commission has already and properly rejected the LECs' contention that they should be permitted to respond on a contract basis to customer-issued requests for proposals. Section IV.E shows that, contrary to the LECs' contention, the proposed 1% upper SBI limit on service categories, where the lower SBI limit has been eliminated and the LEC has priced below the former price floor, will not put unwarranted restraints on legitimate LEC pricing behavior; at the same time, the proposed limit is needed to guard against predatory pricing and cross-subsidization.

Contrary to the LECs' suggestion and for the reasons discussed in Section IV.F, zone pricing of the carrier common line charge, residual interconnection charge and local switching would not lead to rates more closely aligned with costs. Moreover, under the recent telecommunications legislation the Commission is required to conduct a rulemaking on rate averaging. Until that rulemaking is completed, the Commission should not upset the current level of deaveraging in LEC access charges. As many

commenters confirm and as demonstrated in Section IV.G, the Commission should not act on the LECs' basket/service category revision proposals, given that marketplace circumstances do not justify disturbing the current balance of LEC and ratepayer interests embodied in the current basket structure. Moreover, access reform should precede any changes in price cap structure. Finally, Section IV.H shows that, contrary to the LECs' contentions, a separate service category for operator services in the traffic sensitive basket is needed to prevent unwarranted price increases for these services.

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REPLY COMMENTS OF AT&T CORP.

Pursuant to the Commission's Second Further Notice of Proposed Rulemaking ("SFNPRM") in CC Docket No. 94-1, FCC 95-393, released September 20, 1995, and Section 1.415 of the Commission's Rules, 47 C.F.R. § 1.415, AT&T Corp. ("AT&T") submits this reply to other parties' comments on the Commission's proposals to modify the price cap rules for local exchange carriers ("LECs") and to establish a framework for additional "gradations of increasingly less stringent price regulation" for these monopoly carriers.[1]

[1] SFNPRM, ¶ 2. The Common Carrier Bureau extended the time for filing reply comments until February 6, 1996. See Order, DA 96-20, released January 16, 1996. A list of the parties filing comments and the abbreviations used to identify them is contained in Appendix A.

I. THE CLEAREST PROOF OF THE NEED FOR CONTINUED PRICE REGULATION OF ACCESS SERVICES COMES FROM THE COMMENTS OF END USER CUSTOMERS AND LEC AFFILIATES THAT ARE SUBJECT TO THE POWER OF MONOPOLY ACCESS PROVIDERS IN OTHER MARKETS.

The clearest proof of the need to continue effective restraints on LECs' access pricing comes from end user customers and from Sprint and Frontier, which operate in both the local and interexchange markets. Moreover, notwithstanding the LECs' general protestations that they face substantial and rapidly growing competition,[2] the comments of RBOC foreign affiliates which must compete with entrenched local exchange and access monopolists in other countries sound exactly like the concerns expressed by Sprint, Frontier and IXCs. All of these comments unanimously endorse regulatory rules that place strict limitations -- especially price controls -- on incumbent monopolists.

Ad Hoc (at 19-20) concurs with AT&T (at 2-5) and many other commenters that LECs face only "niche competition in limited geographic areas."[3] Thus, despite Bell

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[2] E.g., Bell Atlantic at 4; Pacific at 27; SWBT at 2-3; U S WEST at 2-3.

[3] TCG (at 2) notes that after a decade of competing in New York it still holds only a 0.5% share of the statewide switched access market. See also CCTV, at 14; GSA at 17 ("[t]here is no community in the nation where viable, effective competition is producing market-based pricing for local exchange services"); ICG at 1-2; NCTA at 28.

Atlantic's plea (at ii) for an end to "creeping incremental regulatory reform," Ad Hoc (at 11) urges that:

> "[r]egulatory policy should match reality; it should not be the product of the LECs never ending efforts to persuade regulators that a tidal wave of competition is about to break-out over the LECs."

Based on its experience in both the local and interexchange markets, Sprint (at 3) warns that the Commission must assume that:

> "price cap LECs are dominant for the provision of all interstate access services in all geographic markets . . . [because Sprint's] experience as both an access provider and an access customer . . . has demonstrated that access competition is in its infancy."[4]

Because access competition is "embryonic," Sprint (at 3-4) urges the Commission to "be extremely cautious in evaluating any proposals to grant streamlining or nondominant regulation of interstate access services." Moreover, Sprint also recognizes that "premature deregulation of price cap LECs could be disastrous to both access and interexchange

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[4] See also NYDPS at 2, 5 (even though barriers to entry are being eliminated in New York, "actual competition is still in its early stages"); CCTV at 3. TRA (at 6, 8) concurs, pointing to the Common Carrier Bureau's 1995 conclusion that "the development of competition in local services is roughly a dozen years behind the development of competition in long distance," with LECs still accounting for 97% of access revenues. In addition, TRA (at 8) notes that LECs are installing fiber at a rate many times that of their CAP rivals.

competition."[5] In particular, Sprint cautions that "[s]pecial efforts must be taken to ensure that the RBOCs do not use whatever regulatory flexibility is granted to them to unreasonably favor their own interexchange operations (if or when they are allowed entry into the interLATA market), or to otherwise engage in anticompetitive or discriminatory activity."[6]

Frontier (at iv) similarly urges the Commission to "tread with care" in reducing its supervision of LEC pricing. Specifically, Frontier (id.) recommends that the Commission:

> "should afford exchange carriers significantly increased pricing flexibility only after a concrete showing and affirmative finding that

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[5] See also ALTS at 10 ("LECs control essential facilities used as inputs by potential competitors" and have much more at stake in setting access prices than just access revenues); CompTel at i, ii, 14-15; LDDS at iii, 14 (discrimination in the access market is even more critical and pernicious than discrimination in the interexchange market because access services directly affect interexchange competition); TRA at 2.

[6] See also CompTel at 5, 14-15, 23-25, 40 (opposing special treatment, including contract tariffs, for LEC affiliates). In this regard, the RBOCs' comments completely ignore the impacts of reduced regulation on interexchange competition, especially if RBOCs are given interLATA authority pursuant to the new telecommunications law passed by Congress. This omission is telling. In contrast, LDDS (at 2) predicts that LEC price discrimination, particularly in favor of LEC affiliates, is the greatest regulatory problem in transitioning to a competitive marketplace, in part because LEC incentives to recover overheads on non-competitive services will increase if they enter the interexchange market. See also MCI at 6.

> particular services in particular geographic areas are subject to truly effective and sustainable competition." (emphasis in original)

Frontier (at 16) further suggests that the Commission should require LECs seeking reduced regulation to meet "a high burden of proof [in] demonstrating that competitive conditions warrant substantial decreased regulatory surveillance."[7]

RBOC foreign affiliates that are attempting to compete against entrenched monopoly providers express identical concerns even more forcefully. For example, BellSouth Europe argued last spring to the European Commission that:

> "the incumbent brings enormous structural advantages to the competition in the form of a 'paid for' infrastructure, brand loyalty, consumer inertia, preferential access to data regarding the calling habits of its interconnecting competitor's customers, superior access to infrastructure, established regulatory/legislative relationships, etc."[8]

BellSouth Europe (at 6) further supports the following findings of an independent consultant, which

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[7] NCTA (at 9) also notes that granting LECs pricing flexibility is not a neutral act if it allows LECs to "compete" against "ghost competitors" and harm nascent competition.

[8] Comments of BellSouth Europe to the European Commission's Green Paper on the Liberalisation of Telecommunications Infrastructure and Cable Television Networks, filed March 15, 1995 ("BellSouth Europe Comments"), appended as Appendix B hereto, at 5.

conclude that incumbent monopolists can use many non-price tactics to delay or defeat competition:

> "'Competitors are disadvantaged if they cannot order and obtain leased lines, circuit rearrangements, and enhanced services on reliable commercial schedules that are equivalent to the service a[n incumbent] provides to its own departments or subsidiaries. Experience in liberalised markets (U.S., U.K.) suggests that regulators need to establish a requirement for equal provisioning and to monitor [the incumbent's] performance to ensure equal access.'"

Even more recently, BellSouth New Zealand ("BellSouth NZ") made similar arguments to New Zealand authorities, stating that a "dominant incumbent . . . can and will rationally use interconnection negotiations to delay and restrict the benefits of competition and distort the timing and direction of the evolution of the industry."[9] By doing so, BellSouth NZ (at 2) notes that the incumbent:

> "can limit both the scale and scope of its competitors, raising their costs and restricting their product offerings . . . [in order to] divert or delay competition and innovation to protect its current revenues and to give itself time to prepare and introduce similar products or services by exercising control over standards for interconnection and over local numbers."[10]

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[9] "Regulation of Access to Vertically-Integrated Natural Monopolies, A Discussion Paper," submitted by BellSouth New Zealand to the New Zealand Government, dated September 1995 ("BellSouth NZ Comments"), appended as Appendix C hereto, at 1.

[10] See also id. at 10.

Thus, BellSouth NZ (at 8) recognizes that "the dominant incumbent can and will rationally exploit [the need for interconnection] to perpetuate and increase its monopoly rents" and that the incumbent will "manipulate and impede competition and innovation."[11]

BellSouth NZ (at 9) also confirms that the terms of access are vital to the emergence of competition, because "[t]he terms and conditions for interconnection, and the price of those complementary network services, determine which firms capture what rents, and how." Accordingly (at 10), it recognizes that "[i]t is rational . . . for the dominant incumbent to exploit the regulatory regime to the greatest extent possible . . . ."[12] In its arguments to the UK Office of Telecommunications,[13] U S WEST International (at 8) likewise recognizes that "[i]t is . . . in the

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[11] See also id. at 21 (explaining that the incumbent can maintain its power by "innovat[ing] in ways that protect its existing assets" through dictating terms of access and other means that control the pace and direction of innovation). This is a key reason why new access services should be subject to significant scrutiny by the Commission and comment from potential users and competitors. See Section IV.A, below.

[12] See also ALTS at iii ("LECs will duck and dodge their pro-competitive obligations until it is convenient for them to comply unless their own deregulatory agenda is also at stake").

[13] "A Framework for Effective Competition, A Response to OFTEL's Consultative Document," submitted March 30, 1995, appended as Appendix D hereto ("U S WEST International Comments").

dominant operator's self-interest to make interconnection as difficult and expensive as possible."

Because of incumbents' inherent advantages -- advantages which are in many ways analogous to those held by LECs in the United States -- BellSouth NZ (at 3) acknowledges that potential competition alone is ineffective to control a dominant incumbent.[14] BellSouth Europe (at 7) even argues that the "best way to ensure neutral treatment for all service providers is to organizationally separate the incumbent's infrastructure and service provisioning units."[15]

All three RBOC affiliates are especially concerned with incumbents' ability to control access pricing. Because of the critical competitive importance of the incumbent's access services and prices, BellSouth NZ (at 67) proposes that access pricing should be based on principles which are

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[14] "The mere threat of entry will not provide the mechanism of dynamic competition, which requires that firms continually compete and interact with each other in the market place". See also id. at 22; MFS at 7; TRA at 5; AT&T Comments, App. A at 12-14 (given the structure of the local and access markets, standards for reviewing potential competition must be extremely demanding).

[15] See ICG at 5-6 and LDDS at v-vi, 24-25 (urging the Commission to impose structural separation on domestic LECs). See also BellSouth NZ at 10 (recognizing that cross-subsidization between an incumbent's monopoly and competitive services is likely, because the dominant firm "has very powerful incentives to include monopoly rents in the price of complementary network services"); CompTel at 11-12.

identical to many of the preconditions for competition identified by numerous commenters in this proceeding.[16] These principles include mandatory interconnection of networks in conjunction with an incremental cost test; reciprocity of interconnection charges; non-discrimination across network operators for the same service; unbundling of interconnection charges;[17] and exclusion of monopoly rents from interconnection charges. BellSouth NZ (at 70) further proposes that the incumbent should use a "best practices" technology standard in calculating its costs, so that competitors do not have to pay for its inefficiencies.[18]

BellSouth Europe (at 4) firmly supports the European Commission's position that "'[r]egulatory authorities should have a responsibility . . . for ensuring . . . cost-oriented pricing structures,'" and it suggests that this should be accomplished "by insisting on LRIC-based interconnection charges." BellSouth Europe (at 13) further proposes that an incumbent's interconnection

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[16] See, e.g., AT&T at 6-7; CCTV at 8-10; Comcast at 15-16; MCI at 21-29; Sprint, Att. at 1-5. These checklists, however, do not demonstrate that there is actual competition, only that the preconditions for effective competition are in place (see Section III.D.1 infra).

[17] Unbundling is necessary to prevent an incumbent from engaging in a price squeeze of rivals. BellSouth NZ Comments at 72.

[18] See also id. at 74-75.

charges should "reflect long-run incremental costs (LRIC) caused by the interconnection," and that such costs should be "reduced to factor-out the incumbent's structural market advantages and superior access advantages (if any)."[19] Even with LRIC-based prices, however, BellSouth Europe (at 6) concurs with the findings of an independent study that "'[e]ven with interconnection charges set as low as marginal or incremental costs, the incumbent is unlikely to lose its market quickly.'"[20]

U S WEST International (at 2) is especially clear on the issue of pricing, strongly supporting the principle that access providers "should be recompensed for costs actually incurred in interconnection; but that is all."[21] Moreover (id.), it urges -- and AT&T agrees -- that interconnection rates:

> "should be calculated through a 'bottoms up' approach, which identifies the cost drivers and their long run incremental cost (LRIC) including the appropriate contribution to the cost of

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[19] Emphasis in original. BellSouth Europe (at 5) also supports a proposal that there should only be a partial funding of the incumbent's economic losses from providing interconnections to competitors, in order to give the incumbent incentives to increase its efficiencies.

[20] See also Time Warner at 9.

[21] See also CompTel at 2, 15 (access charges should be based on direct costs); ICG at 5; LDDS at 3, 21; MCI at 20-21, 29 (Rochester experience with "wholesale" pricing shows that interconnection rates must be based only on economic cost); Sprint at 2 (access charges are "laden with burdensome subsidies" and require reform).

> capital. There should be no arbitrary mark-up to this LRIC."[22]

U S WEST International (at 12) also agrees with the BellSouth affiliates that LRIC should be forward-looking, and it supports the proposition that competitors should not have to pay for inefficiencies in the access provider's network.

Finally, U S WEST International rejects the notion that incumbents should be allowed to recover overheads in their access rates. Instead, it asserts (at 2) that all services other than interconnection should be defined as "'retail' and [that] operators should recover their overhead and other costs in this [retail] market, where competition will force them to allocate their costs in the most efficient manner."[23]

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[22] Realization of a fully cost-based access charge regime in the U.S. is in some ways more difficult than abroad because of the dual federal/state jurisdictional regime, through which subsidies in interstate access rates have become institutionalized.

[23] See also U S WEST International Comments at 13-14 ("The provision of call completion . . . is more properly seen as a cost which should be recovered, rather than as a source of revenue. Operators should make their 'mark ups' on their retail services. . . . Telephone operators do not set-up in service to serve each other for interconnection; their aim is to retail service to customers. It is these customers who should pay the 'overhead' costs of the operating company . . . It is not the job of other operators to ensure that one particular company's overheads are met"); CompTel at 2 (pricing flexibility should be limited to retail services).

The above comments from customers and carriers that operate in both competitive and non-competitive markets completely refute Pacific's claim (at 36-37) that "[n]o one has ever described a lawful or even plausible mechanism that would enable BOCs to leverage their access facilities . . . into other markets." Moreover, they provide compelling evidence that the Commission should promptly implement effective access reform that requires access prices to be at direct economic cost and nondiscriminatory for all access customers, including LEC affiliates.[24] Accordingly, the Commission should defer any significant structural changes in price cap regulation of LEC access services until that process is complete.[25] In all events, the Commission should heed Sprint's and Frontier's warnings and act with extreme caution before instituting any major access reforms or removing any LEC access services from price caps.

II. MARKET DEFINITION ISSUES

Numerous commenters[26] agree that the lack of competitive conditions in the local exchange and access

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[24] See CompTel at 17-18; LDDS at 23; MCI at 21; NCTA at 10.

[25] See Section IV.G., below.

[26] Ad Hoc at 30-31; ALTS at ii; CCTV at 6; Comcast at i; CompTel at 39; ITTA at 4-5; MCI at i; NCTA at 29; Sprint at 25.

markets do not warrant consideration of streamlining at this time,[27] for the reasons set forth in Section I above. Nevertheless, Sections II and III reply to comments on the market definition and market power assessment issues the Commission will have to consider if and when substantial long-term competition emerges in those markets and consideration of streamlining would thus be appropriate.

A. It May Be Appropriate to Use Wire Centers to Define Geographic Markets.

The comments do not support the Commission's proposal to use the existing rate density zones as the basis for defining geographic markets.[28] Moreover, notwithstanding the Commission's reluctance to use LEC wire centers to define geographic markets, many commenters -- particularly LECs -- propose market definitions that are based on wire centers.[29] Other commenters propose larger areas for the Commission's consideration.[30]

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[27] Consideration of nondominance for LEC access services is clearly premature (see, e.g., Sprint at 28.).

[28] Those expressly opposing the use of density zones include GTE at 49 (noting that density zones are not contiguous so that customers could not obtain substitute supply across such areas); Ad Hoc at 30; Ameritech at 37; AT&T at 13; Comcast at 5; NYNEX at 40; SWBT at 56; TRA at 18; Time Warner at 49; U S WEST at 34; USTA at iii. See also MCI at 31 (use density zones only for trunking).

[29] Ameritech at 4; BellSouth at 49; GTE at 48; Pacific at 42; SWBT at 57; USTA at 41.

[30] NYNEX at 42 (LEC should be given flexibility to define geographic market); SNET at 21 (allow PUC-defined areas,

(footnote continued on following page)

No one can accurately predict exactly how, whether, and where competition will emerge in local markets. Nevertheless, with the metrics AT&T recommends in its comments to determine whether there is effective competition,[31] AT&T would support the use of individual wire centers as geographic markets, because wire centers are the smallest areas that can practicably be used to define a market.[32] The Commission should also require LECs to geographically average their access prices throughout the whole geographic market after an access service is removed from price caps.[33] These measures will provide reasonable assurance that long-term competition can succeed in the defined area and that the LEC will not be able to exercise market power by raising access prices above market levels.

(footnote continued from previous page)

including Labor Market Areas); U S WEST at 35 (MSAs); Ad Hoc at 30 (all central offices served by a tandem; LATAs); MCI at 32 (areas based on common costs); Time Warner at 48-50 (same, but LATAs permissible if competition is pervasive).

[31] AT&T at 17-18 (prima facie showing of competitiveness includes proof of two or more non-LEC facilities-based competitors that are available to at least 75% of the subscribers and which have a minimum 30% market share).

[32] See SWBT at 57; GTE at 48. Wire centers are thus a reasonable compromise between the very narrow geographic market definitions that would be called for under strict economic theory and the Commission's need for adminstrable rules.

[33] See AT&T at 13-16; Time Warner at 44.

AT&T also supports the "footprint" approach advanced by SWBT (at 56-57) and others,[34] which would allow a LEC to aggregate contiguous wire centers into one geographic market based upon a showing of sufficient facilities-based competition in each wire center. Such aggregations would make the administrative process easier and more practical, especially in cases where the placement of competitors' facilities does not exactly coincide with specific LEC wire centers. In those situations, the Commission should apply the AT&T metrics (and the rate averaging requirement) across all the wire centers in the proposed market, but it must also assure that there is substantial facilities-based competition in each wire center the LEC seeks to include.[35] Otherwise, areas with no effective competition could be swept into the analysis based on the coincidence that they are near -- but not within -- areas with effective competition.[36]

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[34] E.g., Ameritech at 38; GTE at 51; USTA at n.70.

[35] See GTE at 51.

[36] To the extent LECs may wish to propose other geographic markets based upon a specific competitive situation (see, e.g., NYNEX at 42), the burden of proof of the reasonableness of the proposed market should be upon the LEC, and the Commission should consider the principles discussed above and in AT&T's comments (at 14-16).

B. Product Market Definition

1. Access Elements Are Interrelated And Cannot Be Viewed In Isolation.

The commenters offer numerous suggestions on ways to define the relevant product markets for interstate access services. Nearly all of them, however, ignore the key difference the Commission identified between LEC access services and interexchange services, namely that LEC baskets are arranged around network functionalities, while interexchange baskets were organized according to end user demand.[37] Thus, it appears that most commenters incorrectly assume that each access service -- which is in reality a mere component of overall access[38] -- can be assessed in a vacuum as to whether it constitutes a discrete product market.

Any such assumption, however, is foreclosed by TCG's showing (at 3-4) that a large majority of its own local switched service revenues in New York are paid over to NYNEX and that, even though Sprint selected TCG to provide all of the local transport services for Sprint's switched access services in the New York LATA, NYNEX continues to receive 96% of Sprint's payments for switched access.[39]

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[37] SFNPRM at ¶ 131.

[38] AT&T at 9.

[39] See also Sprint at 25.