transitional pricing standards such as Short Run Marginal Costs ("SRMC").[45]

[133] Loop costs vary significantly by population density zone. Therefore, rates should be determined on the basis of the cost information by density zone in the Hatfield model. Either the specific grouping of cost results shown in the model could be applied, or the states could be given discretion to aggregate the underlying study results into density groupings based on their own unique circumstances.

[133] It would not be necessary to recompute TSLRIC costs each year. If initial rates for unbundled network elements are established at TSLRIC, the Commission should use those rates as ceilings for a period of time for example, three to five years. Large productivity factors are needed in the current price cap system because initial rates were based on embedded costs, which greatly exceed economic costs. If rates for unbundled network elements were set at TSLRIC, the Commission could safely avoid reviewing productivity issues for several years. If competition is developing satisfactorily, there may be no need to revisit the costing process. On the other hand, if it appears that LECS are retaining substantial market power, a performance review would be necessary after the initial price cap period.

C. The Hatfield Model Should Be Used to Set Rates

[137] The Hatfield Model should be used to determine the TSLRIC costs of unbundled network elements and other interstate rate elements on a state-by-state basis. The March, 1996

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[45] SRMC assumes fixed capacity and measures only variable expenses. The Commission is correct that the use of SRMC as a pricing standard for interconnection and unbundled elements would produce positive incentives for ILEC bargaining, and should be used in the event the Commission should require further cost-modeling based on inputs currently in the exclusive possession of the ILECs.

Hatfield Report reported nationwide costs for interconnection and unbundled network elements. A version of the Hatfield Model that generates state specific rates is described in the AT&T Comments in this proceeding. That version of the model uses extensions to the BCM Model to generate state specific results. As the March Report noted, state specific results were not presented then "because it takes considerable time to produce loop investment results for the whole country."[46] Over the last two months, AT&T and MCI have commissioned significant resources to accomplish this task. This model represents the only comprehensive nationwide analysis of virtually all network elements on a highly disaggregated basis. It is the ideal standard for the Commission to adopt, because it will provide immediate certainty on pricing, which is necessary for local competition to develop quickly.

[134-137] Traditional ILEC cost studies should not be used for rate setting or proxy purposes. These models are biased because they often incorporate embedded ILEC costs. They also are suspect due to their use of proprietary data that cannot be verified.[47] An advantage of the Hatfield Model is that it does not depend on ILEC cost studies.[48]

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[46] Hatfield Report, p. 33

[47] In a Utah Public Service Commission proceeding, U S WEST agreed to provide AT&T access to the U S WEST cost model, "under appropriate protective conditions." [See Transcript of April 30, 1996 Hearing] In subsequent negotiations, the appropriate conditions turned out to be so unreasonable and restrictive as to render such "access" useless: AT&T must review the U S WEST model only at U S WEST offices, AT&T is permitted to send only two persons to review model, U S WEST will not reveal certain proprietary equipment information, and any persons reviewing U S WEST's model must agree never to be involved in interconnection negotiations with U S WEST.

[48] At the time of divestiture, it would have not been possible to produce an independent telephone company cost model. Costs within the vertically integrated Bell System were not transparent. With the onset of equipment competition, it became possible to observe

[138] The rates in existing interconnection and unbundling arrangements provide valuable information that verifies the reasonableness of the Hatfield model results. However, it would not be useful to use existing interconnection rates to directly set rates or rate ceilings. Existing rates have been developed under a variety of methodologies in different states and therefore lack the consistency needed to ensure uniform nation-wide development of competition.

[139-140] Similarly, existing rates for access services do not provide a reasonable basis for establishing ceilings for unbundled network element prices. The use of embedded costs and the arbitrary separations process have generated rates that are excessive and unrelated to principles of cost causation.[49] The fact that these rates have been subject to price cap regulation does not change this problem, because the going-in rates were set on embedded costs. The problem has never been remedied, and in fact has been exacerbated because this Commission and state commissions have consistently underestimated productivity gains reasonably available to ILECs.

D. Other Costing Issues

[147-148] The Efficient Component Pricing Rule ("ECPR") has been advocated by ILECs before several state Commissions, but has not been adopted by any of them. The Commission is correct that the ECPR is inherently in conflict with the objective of the 1996 Act to eliminate

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or estimate market prices for key inputs into such models.

[49] Chairman Hundt recently pointed out that ". . . the current system of access charges is both unfair and unsustainable. It is unfair because our current rules overcharge some people, give others a special deal they don't necessarily need, and give potential competitors distorted investment goals." Reed Hundt, Chairman, Federal Communications Commission, speaking before Deloitte & Touche Consulting Group, Telecompetition '95, Washington D.C., December 5, 1995.

impediments to competition. Among the problems with this rule is that it effectively allows ILECs to recover non-economic costs from their competitors -- indeed, since interconnection is the ultimate bottleneck, with inelastic demand, the ECPR guarantees imposition of non-economic costs on competitors. The basic flaw in the approach is that it starts from existing revenue requirements and constructs contribution markups necessary to raise that level of revenue regardless of market conditions. This is directly contrary to the Act's prohibition on the use of embedded costs. As a result of these and other problems, several states have rejected ECPR.[50]

[155-156] "Nondiscriminatory" must be interpreted to have a different, and more stringent, meaning than the phrase "not unreasonably discriminatory" as used in the 1934 Act. Reasonable discrimination is not allowed under the 1996 Act. An ILEC may not deny to one carrier interconnection, access, or resale arrangements that it offers to another or to itself. If Congress had intended to authorize the Commission, state commissions, or ILECs to permit discrimination so long as it was reasonable, it would have prohibited only "unreasonably discriminatory" arrangements, as it did in Section 202(a) of the 1934 Act.

[155-156] The anti-discrimination provisions in Sections 251 and 252 do not require ILECs to charge the same rates regardless of whether they incur different costs to serve different customers. ILECs may, and indeed must, charge cost-based rates, so they can charge different rates to customers that it costs more to serve than other customers, provided that ILECs charge the same price to all customers for which the cost of service is the same. Thus, for example,

[50] For example, Maryland rejected the ECPR in MFS Phase 2, Case No. 8584, pp. 22-25 (December 28, 1995)(Order No. 72348)(citing Order No. 71485).

volume and term discounts are permissible, provided that they are available on a nondiscriminatory basis to any carrier the size of any such discount is subject to the requirements of Section 202(a) to the extent it applies to interstate services. Similarly, zone density pricing is permissible provided that service is available on a nondiscriminatory basis to all customers within each zone -- again subject to the requirements of Section 202(a) where interstate services are involved.

[157] The critical provision of Section 251(d)(3) is subpart (B), which requires any state regulation, order or policy to be "consistent with the requirements" of Section 251. Joint Explanatory Statement, p. 122 Subpart (d)(3) further authorizes the Commission to preempt state legal requirements that are consistent with the letter of the federal law but nevertheless interfere with accomplishment of its purposes. For example, state orders allowing ILECs to refuse to enter into interim interconnection arrangements permitting competition to begin while permanent arrangements are being developed may not violate any explicit provision of Section 251, which does not expressly require any interim arrangements, but such an order would nonetheless substantially prevent implementation of the purposes of the Act. So too would state action extending all of the requirements of Section 251(c) to non-incumbent LECs. The Commission has the power, and the public interest responsibility, to review such orders.

VI. Regulators Must Take Access Rates to Cost

MCI agrees with the Commission's tentative conclusions that:

- [159] Long distance carriers may combine their facilities with loops and other ILEC elements to provide telecommunications services
- [159-163] Carriers that provide interexchange service may request interconnection and

network elements unde Sections 251(c)(2) and (c)(3).

- [165] Imposing access charges in addition to cost-based charges under Sections 251 and 252 would be clearly inconsistent with the statutory scheme.

In addition, MCI requests that he Commission adopt the following findings:

- Access charge rates must fall to direct economic cost or TSLRIC levels to promote competition and benefit consumers. This result is also mandated by the requirements of Section 251(c)(2) and (c)(3).

A. Embedded Costs Do Not Prevent the Efficient Pricing of Network Elements

[144] The difference between TSLRIC rates and the implicit current rates for unbundled network elements and access is substantial. Comparison of the existing ILEC revenues with the revenues that would be generated from pricing unbundled network elements at economic cost is difficult because "apples to oranges" comparisons are inevitable. Table 5 in the March, 1996 Hatfield Study shows the difference between the existing revenue requirement and revenues that would be generated by TSLRIC pricing of the unbundled network elements. It shows that if, hypothetically, all retail customers were served by competitors using ILEC unbundled network elements, ILEC revenues would be almost $46 billion less than they are today.

[144] However, pricing unbundled network elements (including access) at TSLRIC costs would <u>not</u> result in a $46 billion ILEC revenue loss. First, it will take a substantial amount of time for competitors to achieve any significant penetration of the local market. Second, a large portion of the gap between current revenues and the cost of unbundled network elements shown by the Hatfield Study (33 percent) consists of retail customer operations expenses that can be recovered from end user customers, to the extent competition allows. These costs are not reasonably included in the TSLRIC of unbundled network elements. Third, the most significant portion of the

gap (38 percent) is in the category of "overbuilt plant." The overbuilt plant consists of excess capacity in loops, switches, and buildings. It is not appropriate to recover these costs in the rates for unbundled network elements. However, that does not necessarily imply that the costs cannot be recovered elsewhere. Buildings and real estate no longer needed because efficient provision of telephone service requires fewer and smaller wire centers have economic value independent of monopoly telephone services. Much overbuilt plant may have been installed to provide competitive services such as Centrex, Open Video Services, or interLATA long distance. RBOCs will gain new profits from new products and services and, once statutory requirements are met, new markets that include in-region long distance. For example, growth in existing services (for example, second lines) or the introduction of new services (for example, ISDN or Internet access) may profitably employ existing facilities. Finally, it is important to point out that the corporate operations included in the calculation of the gap is the amount remaining from the LECs total corporate operations costs after subtracting the portion properly allocated to network elements. These residual accounting costs are either (1) costs of competitive ventures (2) miscategorized retail costs, or (3) inefficiencies.

[144] Depreciation reserve deficiencies are a small percentage of the gap (2 percent). This means that ILECs have been able to recover their investments in equipment despite rapid technological change.[51] Theoretically, it would be appropriate to allow ILECs to recover their existing depreciation reserve imbalances. However, some ILEC plant may actually be more

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[51] See Kenneth C. Baseman and Harold Van Gieson, Depreciation Policy in the Telecommunications Industry: Implications for Cost Recovery by the Local Exchange Carriers, December, 1995, p.2.

valuable than the amount carried on ILEC books. For example, long-lived investments in capacity were made at a time when labor was much less expensive. The cost of the labor to install outside plant is capitalized. The replacement cost of these facilities, which are included in the Hatfield Model, would be much higher today. The difference between the net book value and the replacement cost of these facilities most likely offsets the entire depreciation reserve deficiency, if not more. Moreover, ILECs have been modernizing at a rapid pace, installing digital switches and fiber optic capacity. A significant portion of their embedded base of switching and transmission capacity may reflect today's much lower costs of electronic components.

[145] Universal Service funding is an issue for a separate proceeding.[52] However, it must be noted that the TSLRIC rates produced by the Hatfield Model include expenses for both densely populated and less densely populated areas. Therefore, it would not be appropriate to add universal service costs to them. To the extent rates for facilities in less densely populated areas need to be subsidized for universal service purposes, the subsidy should be collected from all carriers on a non-discriminatory and competitively neutral basis. Of course, it would not be appropriate to allow RBOC entry into interLATA markets until the universal service issue is resolved.

[146] If and when local competition develops, it will drive interstate access charges to cost, but, unfortunately, local competition will at best develop only over time. In the meantime, access prices substantially above cost will distort markets and investment and harm consumers

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[52] See MCI Comments filed in Federal-State Joint Board on Universal Service, CC Docket No. 96-45, filed April 12, 1996.

and competition. The Commission has long recognized that above-cost interstate access prices have forced interstate toll prices to be substantially higher than they would otherwise be, and that they have caused inefficient bypass using dedicated access.[53] The Act will increase the economic distortions caused by inflated access charges in at least two ways.

[146] First, inflated access charges will retard the development of local competition. They will create incentives for inefficient investment in facilities and equipment used for both local exchange services and switched exchange access. The existence of the huge access revenue stream will increase further the incentive of ILECs to frustrate entry and competition by denying new local carriers the interconnection, access, and resale arrangements to which the Act entitles them. Moreover, to the extent that ILECs provide interexchange service, high access prices will give them more ways to respond anticompetitively to services offered by new local competitors. High access charges would permit the ILECs to use their pricing of interexchange services to deter entry and investment by competing local carriers.

[146] Second, the ILECs, including the BOCs, could exploit in the long-distance market their cost advantage derived from access overcharges. ILECs would have this advantage over unaffiliated toll carriers that are equally or more efficient. For example, ILECs can effectively increase the costs of unaffiliated toll carriers by inducing them to choose alternative access arrangements for which the carriers pay less but which have higher economic costs than those self-

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[53] High switched access charges induce interexchange carriers to use lower-priced, but higher-cost, dedicated access even when switched access would be less expensive if it were priced at cost. This is true whether dedicated access is provided by ILECs or by competitive access providers.

supplied by the ILECs. These tactics compound the problems created by the ILECs' ability to raise rivals' costs through non-price discrimination.

[146] Reducing access charges to cost would provide immediate benefits to all consumers of access services. Toll carriers that purchase access directly would face lower costs and pass them to customers through competition as lower toll rates. Furthermore, cutting access charges reduces the burden on regulators to implement and enforce complex regulatory rules necessitated by the current access charge system.

[146] The Commission has no basis to assume that the policy considerations that persuaded it to tolerate inflated access charges in the past justify the current access charge system in the new environment. In fact, the Act assures that the consequences of high access charges will be different than they were before. At a minimum, the Commission must therefore re-evaluate its prior justifications in light of the passage of the Act.rchase unbundled network elements at cost, will introduce numerous market distortions. On the other hand, if the rates for unbundled network elements are held above cost in an attempt to limit these distortions, local competition will not develop as rapidly -- if at all -- contrary to the goals of the Act.

B. Access at Cost Is Required by Sections 251 and 252

[164] Section 251(c)(3) does not permit the artificial limitations proposed in the Notice on the type of network elements carriers providing interexchange service may request. The term "network elements" is broadly defined in Section 3(45) to include not only "a facility or equipment" (such as loops), but also "features, functions, and capabilities that are provided by means of such facility or equipment." Exchange access for telephone services is comprised of

features, functions, and capabilities from different facilities or equipment. Under the plain language of the Act, a telecommunications carrier that wishes to provide toll services may request the features, functions, and capabilities included in switching and transport facilities and combine them with elements of its own network to provide toll service. Even if the terms "facility or equipment" could be interpreted to refer, for example, to require "exclusive access to an entire loop", the rest of the definition cannot be construed so artificially. The Notice itself recognizes that "an entire local loop . . . could . . . comprise several network elements",[54] and it unquestionably does. Any limited, inflexible definition of network element would contradict the flexible statutory definition and frustrate the intent to promote competition and efficient provision of services

[159] Similarly, Section 251(c)(2) does not limit the purposes for which any carrier may request interconnection. Subpart (c)(2) permits a carrier to request interconnection so that the ILEC transmits or routes telephone exchange service or exchange access to the requesting carrier. Nothing in subpart (c)(2) requires the requesting carrier to provide exchange service or exchange access; it contemplates only that the carrier will provide a service in which interconnection with exchange service or exchange access is used. Moreover, subparts (c)(2) and (c)(3) should be interpreted consistently, and because subpart (c)(3) clearly permits carriers seeking to originate or terminate toll calls to obtain access to the features, functions, and capabilities that constitute exchange access, it would not serve any statutory purpose to construe (c)(2) to exclude interconnections by which carriers obtain exchange access for toll services. Even under the

[54] Notice at para. 83 (footnote omitted).

Commission's limited and tentative view of the statute, it is clear that long distance carriers are able to participate in subparts (c)(2) and (c)(3) provided that they offer exchange service.[55]

[161] In any event, even if Section 251(c)(2) were incorrectly interpreted to require toll carriers to provide exchange access in order to obtain cost-based interconnection, toll carriers would satisfy this requirement. End-users pay toll carriers, not ILECs, for the function of transporting interexchange calls from their premises to the long distance network: although long distance carriers receive access services from ILECs, the long distance carriers in turn re-offer those access services to their customers; within the meaning of Section 3(a)(40), toll carriers offer access to telephone exchange facilities so that subscribers can originate or terminate telephone toll services.[56]

[162] Nor should the Commission interpret subpart (c)(2) restrictively to bar interconnection by carriers that offer facilities-based exchange access in competition with ILECs. Nothing in the language of subpart (c)(2) requires such a result, and it would frustrate the pro-competitive purposes of the Act to deny cost-based interconnection to a carrier that initially provides a more limited range of services. The word "and" makes clear that the obligation covers both "telephone exchange services" and "exchange access" and that an ILEC may not choose to offer interconnection for one but not the other. Similarly, the Commission should not undertake

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[55] Notice at para. 9.

[56] Long distance carriers do not resell exchange access within the meaning of Section 251(C)(4) because ILECs do not offer exchange access at retail to subscribers who are not telecommunications carriers. But long distance carriers, not ILECs, do provide exchange access to subscribers as part of the retail toll service that long distance carriers provide.

to develop and enforce some test to determine whether a toll carrier established an affiliate (a) to evade (otherwise unjustified) rules intended to protect inflated ILEC access charges or (b) to offer exchange access using its own facilities to any degree. The regulatory morass into which such an undertaking would drag the Commission only demonstrates the artificiality of the lines the Notice proposes to draw.

[161] Section 251(g) is consistent with interpreting Sections 251(c)(2) and (c)(3) to require cost-based rates for interconnection and access for toll services. Section 251(g) requires LECs to continue to comply with "the same equal access and non-discriminatory interconnection restrictions and obligations (including receipt of compensation)" adopted before passage of the Act "until such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after such date of enactment." (Emphasis added.) As the Notice indicates, the ILECs have argued that the rules concerning "receipt of compensation" include the current rules on access charges that allow ILECs to receive compensation far in excess of the cost of providing exchange access. This reading of Section 251(g) directly contradicts the ILECs' contention that other provisions of Section 251 do not address the ILECs' receipt of compensation from telecommunications carriers that provide toll service. Congress plainly intended the other provisions of Section 251 to change the regulations preserved on a temporary basis in subsection (g), including regulations relating to receipt of compensation. As the legislative history confirms, Section 251(g) maintains the status quo only "[i]n the interim, between the date of enactment and the date the Commission promulgates new regulations under this Section," that is, Section 251's implementation provision, Section 251(d). Joint Explanatory Statement, at 123 (emphasis added).

Under the ILECs' own interpre ation that the "receipt of compensation" language in subsection (i) refers to existing rules setting t le level of access charges, this subsection would be wholly unnecessary if other portions o Section 251 did not require a change in these rules on access charges.

[164] Interpreting subp rts (c)(2) and (c)(3) to apply to exchange access for toll carriers would not effect a fundamental jurisdictional shift. The short answer to the ILECs' contention is Section 251(i). Subsection 25 (i) expressly saves the Commission's pre-existing authority regarding interconnection for i terstate services under Section 201 of the Act.[57] (Inclusion of subsection (i) also demonstrate that other portions of Section 251 apply to exchange access; if they did not, subsection (I), lik subsection (g), would be unnecessary.) In any event, the Commission recognizes that in erexchange access charges must be reformed consistently and simultaneously with other inte connection and access arrangements.[58] Sections 251 and 201 lead to the same place: immediate rovision of interconnection for exchange access at cost-based rates.

[164]The Commission controls the rate-setting process at the front end because Section 251(d) requires it to in plement rules for setting rates for interconnection and access required by Section 251(c), an l once the Commission promulgates its regulations, state commissions must apply those standards in adjudicating disputes among carriers and in reviewing

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[57] See also § 601(c)(1) (" This Act and the amendments made by this Act shall not be construed to modify, impa r, or supersede Federal, State, or local law unless expressly so provided in such Act o amendments.") (emphasis added).

[58] Notice at paras. 3, 16

negotiated agreements and statements of generally available terms consistent with the procedures in Section 252.[59]

[164] The Commission also controls the process at the back end when it reviews complaints that an ILEC seeks to charge more for access than the Act and the Commission's implementing regulations permit. As Section 251(i) confirms, the Commission retains its authority under Sections 205 and 208 to determine that any charge imposed by any carrier is not just and reasonable or is otherwise unlawful. The Commission can also direct the ILECs to file tariffs offering exchange access for interstate services at whatever rates the Commission determines are just and reasonable as defined in Section 252(d).

[164] In short, the Act establishes a single scheme of regulation of the terms and conditions on which ILECs must provide interconnection and unbundled access to any telecommunications carrier, thereby implementing congressional intent for a single national set of rules and standards to govern both intrastate and interstate interconnections.

[164] Even if the Commission were to conclude that Sections 251 and 252 directly apply only to the interconnections between ILECs and competing carriers and do not apply to exchange access for interexchange services, it would be arbitrary and capricious for the Commission to conclude its Section 251(d) rulemaking without considering the proper pricing of exchange access for interexchange services.[60] It would not be in the public interest to allow ILECs to charge one

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[59] See, e.g., Sections 252(c)(1), 252(f)(2).

[60] See Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Ins. Co., 463 U.S. 29, 43 (1983) (agency cannot fail "to consider an important aspect of the problem"); Policy and Rules Concerning Rates for Dominant Carriers, 2 FCC Rcd 5208 ¶ 1 ("contin-

(cost-based) rate when they provide interconnection or access used for one purpose, and a different (non-cost-based) rate when requesting carriers use the same arrangement for different purposes. Given the interrelationship of pricing for all kinds of interconnections and network elements, addressing these issues on a piecemeal basis would be inefficient and wasteful of the Commission's and the parties' resources.

[165] Moreover, unless and until access charges are reduced to cost, the Commission may not find under Section 271(d)( )(C) that BOC entry into the interexchange business is in the public interest. Regardless of the price imputed to the interexchange affiliate, the out-of-pocket cost to the BOC of providing exchange access is its economic cost, not the inflated charge that unaffiliated long distance carriers pay. Given the possibility of early applications filed under provided in Section 271, the Commission cannot wait to design and implement a major reform of its access charge rules until after the BOCs start applying for entry into the interLATA market. In order to comply with the Act's purposes of permitting interLATA entry by BOCs as soon as possible when consistent with the public interest, the Commission must begin its access charge reform now.

VII. Resale Obligations of Incumbent LECS

MCI agrees with the following tentative conclusions from the Notice:

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uing obligation to review [Commission's policies and rules to determine whether they continue to further the public interest" given change in circumstances) (citing Geller v. FCC, 610 F.2d 973, 979-80 (D.C. Cir. 1979)); Mobile Communications Corp. v. FCC, __ F.3d ___, 1996 WL 99415, *6 (D.C. Cir. 1996) ("[A]mendment of the Communications Act necessarily alters any analysis of what is in the 'public interest,' which is not an issue of abstract political economy but of fulfilling the congressional view of the public interest.").

- [175] "[R]estrictions and conditions are likely to be evidence of an exercise of market power, ...the range of permissible restrictions should be quite narrow."

- [178] "[T]he Commission is authorized to promulgate rules for the states in applying section 252(d)."

MCI requests adoption of the following additional findings:

- [173-175] The Commission should explicitly identify a minimum list of ILEC services as available for resale in order to facilitate rapid provision of ubiquitous service by new entrants:

  - 1MB, 1MR, 1FB, 1FR
  - Custom calling features (including all CLASS services)
  - Call blocking services
  - Voice messaging
  - ISDN BRI and PRI
  - Flat-rated and measured trunk services (including all types of PBX trunks)
  - ANI over T-1
  - Data Services
  - Promotions, optional calling plans, special pricing plans
  - Calling card, directory services, operator services
  - IntraLATA toll
  - Public access line service
  - Semi-public coin telephone service
  - Foreign exchange services
  - Video dialtone
  - Centrex and all feature packages

  In addition, for each retail ILEC service, the existing databases and signaling that support that service must be provided as part of the wholesale service available to new entrants for resale.

- [179] The methodology and results of the attached study, "The Pricing of Wholesale Rates," should be adopted as the methodology for calculation of avoided cost discounts. The total company avoided cost discounts produced by the study should be declared by the Commission to be presumptively valid. States can adopt a different resale discount upon a showing that the model does not produce an accurate result.

- [173] The Commission should require ILECs to periodically compare the service quality provided to resellers with the service quality they provide themselves, as a mechanism of enforcing nondiscriminatory provision of resale services.

- [173] The Commission should require ILECs to meet the minimum requirements to ensure competing carriers receive parity in access to operations support systems, as listed in Table 1, supra

A. Retail Competition Benefits from Unrestricted Resale Opportunity

[172] Section 251(c)(4) establishes resale as a market entry alternative. A wholesale product is essential when a competitor seeks to enter the market, since it is likely that the competitor has few, if any, network facilities, and a small, dispersed customer base. It will not be economical for a new entrant to build out to meet all of its potential customer base initially. That will occur over time. If properly implemented, a pro-competitive resale rule will permit a new entrant to provide ubiquitous service, giving customers a choice of carriers immediately.

[174] Section 251(c)(4) prohibits ILECs from excluding any service from resale, with the exception of subpart B, in recognition that ILECs have no incentive to make resale a viable option for new entrants. ILECs will attempt to prevent new entrants from using resale to provide ubiquitous local service by: (1) placing restrictions on resale services; (2) providing inferior services for resale; and (3) understating avoided retail costs, thus raising resale rates. The 1996 Act also clearly requires only ILECs to provide services for resale at wholesale rates. Section 251(c)(4) is an additional obligation imposed on ILECs, over and above the 251(b)(1) obligation for all LECs to make services available for resale on a nondiscriminatory basis.

[175] A monopoly firm can enhance its profits by charging higher prices to certain customers for essentially the same product sold to others at lower prices, a practice known as price discrimination. Resale can be a successful way for new entrants to gain a foothold into such a market if the entrant is able to break down existing market segmentation, either by purchasing services from the market segments receiving the most favorable price and reselling them to customers to whom the monopolist charges higher prices, developing altogether new services and markets, or combining resold services with its existing facilities to offer new services. In this way,

the reseller undermines the ability of the monopoly ILEC to profitably maintain prices above cost, an expression of price discrimination based on market power. Thus, resale will be an important part of the transition of a new entrant to facilities-based competition.

[175] For resale services to play this role of eroding market power, the Commission must require ILECs to provide all services to competitors at wholesale rates, including discount plans, promotions, and other service options. This requirement ensures that both the ILEC and its competitor have an equal opportunity to be compensated for the underlying costs of the retail services offered to customers. The ILEC is fully compensated by its competitor for its costs, less any retail costs it avoids, and the competitor will not face a competing ILEC retail price (e.g., a "promotional rate") below its cost of obtaining service from the ILEC at wholesale. If ILECs are allowed to exclude promotions and other special discounts from resale, then resale will not produce the market discipline that is one of its foremost contributions to competition. Providing unrestricted resale of all ILEC retail products, subject only to the statutory limitation in subpart B, is the fastest way to stimulate competition in the local marketplace and give consumers choices in local telephony.

[175] ILECs have attempted a variety of techniques to limit competitor's opportunities to engage in resale. For example Ameritech's proposed resale tariffs in ICC Docket No. 95-04458[61] deny the reseller the ability to purchase a multi-service bundle at wholesale rates. Table 5, below, shows that Ameritech's proposed wholesale rates are approximately 21 percent lower than the

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[61] See Illinois Bell Telephone Company, ILL.C C. No 20, Part 22; and Section 4, Sheet no. 5, No. 5, Part 2, Section 9.

retail rate of each CLASS service when purchased individually. However, the differences between wholesale and retail rates virtually disappear when a customer purchases three CLASS features, and turn negative when four or more features are bundled together. The new entrant, unable to purchase the multi-line service bundle at wholesale, is thus denied the ability to make a pro-competitive purchase commitment, and will be unable to offer the lower average cost of a multi-line bundle when competing for single service customers. This resale restriction perpetuates ILEC's market power.

Table 5
Limiting Wholesale Rates To Basic Services Undermines Resale Competition

		Monthly Retail Rate	Monthly Wholesale Rate	Wholesale Discount
Unbundled	Call Waiting	$2.50	$1.98	21%
Unbundled	Call Forwarding	$2.50	$1.98	21%
Unbundled	3-Way Dialing	$2.50	$1.98	21%
Unbundled	Speed Dialing	$2.50	$1.98	21%
Bundled	3 Features	$6.00	$5.94	1%
Bundled	4 Features	$7.00	$7.92	-13%

[175] Another way ILECs may limit resale is by withdrawing a service to all but its "grandfathered" customers. If only existing ILEC customers may purchase a service, the ILEC would be engaging in discrimination against existing customers of both the ILEC and new entrants that do not currently receive the service. We have already witnessed US West's attempt to limit the resale of Centrex by making Centrex unavailable, except to its existing Centrex

customers.[62] Centrex is voice-grade telephone service, offered to multi-line customers at rates that discriminate against single line telephone customers. ILECs segment the voice-grade market by making multi-line purchase a condition of service. A reseller would be able to purchase Centrex and offer its low-volume customers service on a single line basis, thus eliminating the price discrimination that the ILECs have established. The Commission should therefore permit an ILEC to withdraw a service for resale availability only if the ILEC can demonstrate it has no demand for service, either at wholesale or retail rates, or that it has been effectively replaced by another service at comparable rates, terms, and conditions.

[175] Other proposed remedies for ILEC discriminatory withdrawal of a service, such as the availability of unbundling of network elements, should not be considered. Sections 251(c)(3) and (4) of the 1996 Act impose a duty on ILECs to provide both access to unbundled elements and nondiscriminatory resale services. Consequently, the Commission should not rely on the provision of unbundled network elements as a cure for a flawed resale policy.

[175] The Commission must also ensure that ILECs offer resellers the same quality service they provide to themselves and their own retail customers, in order to minimize the restrictions ILECs might place on resold services. In order to accomplish this, ILECs must install systems and procedures that permit the ordering and use of wholesale facilities under the same timetables available to the ILEC. These systems must include:

- <u>Pre-Service Ordering Capabilities</u>. On-line access to all information needed to verify availability of services and features, scheduling of service installation, and number

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62/ US West has proposed withdrawing its Centrex service in all 14 states in which it is currently offered, and grandfathering its existing customers until the year 2005.

assignment.

- <u>On-line, automated order processing.</u> Capability of transmitting customer orders to the switch office and provide the reseller with notice of confirmation and completion of its order. Competitively-neutral long distance and local presubscribed carrier administration processes must be implemented.

- <u>Exchange of billing data and exchange of customer account data</u>. This must be done on a confidential basis.

- <u>On-Line Monitoring</u>. Monitor the network, isolate trouble spots, perform network tests, and schedule repairs.

- <u>Service quality reports</u>. Documenting service quality ILECs provide themselves compared to the service they provide to others.

A list of minimum requirements needed to ensure competing carriers parity in access to operator support systems is presented in Table 1.

[176-177] There is no need to restrict resale, other than the statutory exception in Section 251(c)(4)(B) against reselling service to a different class of customers, an exception which should be construed narrowly. MCI believes that the intent of the exception language is to restrict resale of residential local service to business customers. There should be no general restriction placed on resale of services that are priced below cost. If a retail rate is below cost (<u>e.g.</u>, in a high cost area), then the ILEC does not lose any net revenue if the wholesale rate is equal to the retail rate less avoided cost. The Joint Conference Report provides no evidence that resale should be limited due to a carrier receiving a universal service subsidy.[63] As the provider of the facility, the

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<u>63/</u> The Joint Conference Report at page 126 states "[t]he wholesale rate for resold telecommunications services under new section 251(c)(4) is to be determined by the State commission on the basis of the retail rate charged to subscribers of such telecommunications services, excluding costs that will be avoided by the incumbent carrier."

ILEC is entitled to any universal service subsidy that the new universal service rules deem reasonable.

B. Commission Should Adopt Resale Discounts That Are Presumed Valid

[180] MCI has provided a study, entitled "The Pricing of Wholesale Services," with these comments, that calculates the size of the avoided cost discount for the seven RBOCs and GTE.[64] This wholesale discount study should be adopted by the Commission as the methodology for calculation of avoided cost discounts. In addition, the total company avoided cost discounts produced by the study should be declared by the Commission to be presumptively valid. States would be able to adopt a different resale discount upon a showing that the model does not produce an accurate result.

1. The Wholesale Discount Study Produces Reasonable Discount Levels That Are Consistent With the Statutory Standard

[181] The wholesale discount study develops its estimate of avoided costs by applying conservative assumptions that are easily replicated with publicly-available information. The model estimates the total expenses that each company would have historically avoided had it provided only wholesale services. This is a simple and reasonable approach since it avoids complicated cost studies that would be needed to estimate avoided costs on a service-by-service basis.

[181] The model considers all marketing, billing and collection, and other operating costs that are not related to the provision of telecommunications services for resale as avoided costs. In addition, the model removes overhead and non-operating costs as avoided costs, in proportion to

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64/ <u>See</u> Attachment 2 to these comments.

total avoided operating costs. Avoided expenses are calculated using publicly available financial and operational data from the FCC's Annual Automated Reporting Management Information System (ARMIS) report 43-03 again making the application of this model a quick and straightforward task, and consistent across ILECs.

[181-182] The model specifies the accounts from the Uniform System of Accounts (USOA), or cost categories within accounts, that the ILECs are able to avoid when providing wholesale service, and requires that these costs be excluded when determining the wholesale discount. This approach has a number of advantages: (1) it will provide estimates of avoided costs that are clearly defined and consistent for all ILECs; (2) it relies on public data that are already available, and does not require in-depth cost studies to be performed by each ILEC; (3) it estimates avoided costs at a fairly high level of aggregation, thereby reducing administrative and modeling complexity; and (4) it obviates the need to allocate joint and common costs across individual services.

[181] The model's avoided cost discount ensures that the ILEC's mark-up above costs is the same for its wholesale services as for its retail services. The wholesale discount calculation is consistent and fair across all companies. The study finds that, among the RBOCs and GTE, current avoidable costs range from a high of 33.15% for Ameritech, to a low of 25.63% for US West.

[182] The study's discount factor should be applied to all services offered by a carrier. Requiring states to estimate the avoided retail costs on a service-by-service basis would create a cost study burden on the states, raise ILEC complaints about confidentiality, severely delay the

determination of wholesale rates, and give the ILECs the discretion to price anticompetitively. Moreover, requiring states to estimate wholesale reduction factors which vary by service would not necessarily produce more efficient rates, since the retail rates on which they are based include large amounts of ILEC inefficiencies.

2. Results of the Wholesale Discount Study Should Be Adopted by the Commission as Presumptively Valid

[181] The Commission should adopt the results of the wholesale discount study as the presumptively lawful wholesale discount Parties to Section 252 negotiations could negotiate a different discount (subject to the standard in Section 252(e)(2)(A)). In the context of a Section 252 arbitration proceeding, a state commission could establish a different discount rate based on a showing that the wholesale discount study does not accurately calculate, in that particular case, avoided costs and the resulting discount. For example, an ILEC could attempt to demonstrate, based on information that other carriers have had an adequate opportunity to review, that a correct application of the wholesale discount model would yield a discount lower than the presumptive discount. This approach establishes a consistent national benchmark and facilitates judicial review of discount levels established by state commissions to ensure that they are consistent with the statute and with the methodology established by the Commission.

[181] This approach is fully compliant with the statute. Section 251(d)(1) empowers the Commission to implement the provisions of Section 251(c), including the requirement that ILECs make retail services available for resale at wholesale rates. While the statute specifically provides at Section 252(d)(1) that state commissions establish discount levels, the exercise of state discretion on the selection of a discount level is constrained by the Commission's ability to