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

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In the Matter of	)	
	)	
Implementation of the Local Competition Provisions in the Telecommunications Act of 1996	)	CC Docket No. 96-98

REPLY COMMENTS OF AD HOC TELECOMMUNICATIONS USERS COMMITTEE

Economic Consultants:
Susan M. Gately
Susan Baldwin
Douglas S. Williams
Economics and Technology, Inc.
One Washington Mall
Boston, MA 02108-2617
617-227-0900

Colleen Boothby
Laura F. H. McDonald
Levine, Blaszak, Block & Boothby
1300 Connecticut Avenue, N.W.
Suite 500
Washington, D.C. 20036-1703
202-223-4980

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SUMMARY

Because of the voluminous record and the extraordinary and unreasonable time pressure Congress created in the 1996 Telecommunications Act, the Ad Hoc Telecommunications User's Committee ("Committee" or "Ad Hoc") has limited its reply comments to several key points.

First, these reply comments challenge those commenters who have argued against the development of comprehensive and detailed national interconnection regulations. Because the Act permits voluntary agreements to deviate from the standards in Section 251, comprehensive and detailed federal regulations would not supplant or discourage deviations from the federal model. States would also be free to address their unique demographic, geographic, or other characteristics, if any, through voluntary interconnection arrangements, which may deviate from the federal model, and the FCC's long-established waiver process. Finally, few significant state variations remain to be developed and their benefits would not outweigh the damage that would occur if local exchange competition through a federal interconnection regime is further delayed.

Ad Hoc supports the specific network element unbundling proposals described by MCI and AT&T in their Comments, though they differ somewhat as to specific subelements. The Commission should reject the misrepresentations of several incumbent LECs regarding the technical infeasibility of unbundling local loops into subelements, particularly when at least one LEC has broken

ranks and advocated loop subelement unbundling. Similarly, the Commission should require additional unbundling of local switching into the separate logical functionalities enabled by the physical components

The Ad Hoc Committee's response to commenters who opposed economically efficient pricing standards for interconnection service and unbundled network elements appears as Appendix A to this reply. Appendix A is a study by the Committee's economic consultant, Economics and Technology, Inc., entitled "Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market".

Finally, the Commission must reject attempts to artificially limit the availability of interconnection services and unbundled network elements. In particular, the Commission must reject the ILEC's misrepresentations regarding § 251(g) of the 1996 Act Section 251(g) preserves the Commission's access rules and policies "*until*" they are explicitly superseded. Thus, Congress recognized the overlap between, on the one hand, the interconnection services and network elements required under § 251 and, on the other hand, the interconnection services and network elements required by Part 69 of the Commission's rules. The Act recognizes that users of either are entitled to both, which will require modification of Part 69. The Commission should clarify that the ILECs cannot deny users, IXCs, system integrators, or enhanced service providers access to the interconnection services and network elements required under § 251.

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REPLY COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

INTRODUCTION

The Federal Communications Commission (the "Commission" or "FCC") faces in this docket a voluminous record and an extremely short statutory deadline. In recognition of these constraints, the Ad Hoc Telecommunications User's Committee ("Committee" or "Ad Hoc") has limited its reply comments to the key points discussed below.

I. NATIONAL INTERCONNECTION REQUIREMENTS

No commenter has presented compelling reasons for avoiding comprehensive and detailed national interconnection regulations. Three arguments raised by opponents of a federal interconnection regime merit further response, however.

First, some commenters have claimed that a comprehensive federal regulatory regime will undermine existing interconnection agreements;[1] delay, rather than further, competition;[2] and stifle innovative interconnection arrangements.[3] These commenters ignore one of the key provisions of the Telecommunications Act of 1996 (the "Act" or "1996 Act")[4] -- the voluntary negotiation process for establishing interconnection arrangements. The Act specifically provides that agreements reached through voluntary negotiations between carriers need not comply with the standards in Section 251 (and, by implication, the regulations implementing that section and developed by the Commission in this docket):

> [A]n incumbent local exchange carrier may negotiate and enter into a binding agreement with [a] requesting telecommunications carrier or carriers *without regard to* the standards set forth in subsections (b) and (c) of section 251. The agreement shall include a detailed schedule of itemized charges for interconnection and each service or network element included in the agreement.[5]

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1 *See, e.g.,* Comments of the Staff of the Indiana Utility Regulatory Commission at 19.

2 *See, e.g.,* Comments of the People of the State of California and the Public Utilities Commission of the State of California on the Notice of Proposed Rulemaking at 17; Comments of the Georgia Public Service Commission on the Notice of Proposed Rulemaking at 2-3, 6; Comments of the Public Utilities Commission of Ohio at 8 (establishing national rules would make negotiations "a farce"); *Cf.* Initial Comments of Kansas Corporation Commission at 5 (supports national standards because they promote competition and aid negotiations).

3 *See, e.g.,* Initial Comments of the Maryland Public Service Commission at 3, 25-26 (national rules would stifle innovative ideas and destroy substantial progress already achieved); Initial Comments of the Oregon Public Utility Commission at 26 (developing prescriptive standards runs risk of prohibiting companies from establishing contract terms that might be needed to fit unique situations); Michigan Public Service Commission Staff at 4 (national rules will cause providers to "back-track and arrange for different types of interconnection" than they have in place).

4 Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act").

5 1996 Act, § 252(a)(1). (emphasis added).

Thus, parties are free to negotiate voluntary agreements for interconnection and unbundled network elements that differ from those required under a federal interconnection regime. Similarly, states seeking to create model agreements that differ from the federal standards will remain free to do so even if the Commission adopts comprehensive and detailed federal requirements. If parties prefer the state requirements to those imposed by the Commission, then parties can adopt those requirements in voluntarily negotiated agreements and avoid compliance with the federal interconnection regime.

If parties cannot reach agreement voluntarily, the Act requires the states to oversee the establishment of a mandatory interconnection agreement that "meet[s] the requirements of 251, including the regulations prescribed by the Commission pursuant to section 251."[6] Thus, comprehensive and detailed federal regulations for mandatory interconnection agreements would not supplant or discourage agreements that deviate from the federal model. The federal regime would merely ensure a level negotiating field -- establishing a reliable safety net for parties seeking a voluntary interconnection agreement if the incumbent local exchange carrier ("ILEC") threatens to "take its ball and go home."[7]

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6 *See* 1996 Act, § 252(c)(1).

7 As discussed in Ad Hoc's initial comments, negotiations conducted without the backdrop of strong national standards disadvantage the party seeking interconnection because that party has little or no negotiating leverage with an ILEC. Some ILECs, like Ameritech, deny that ILECs would have superior bargaining power in negotiating an interconnection agreement. Ameritech insists that parties seeking interconnection who have no negotiating leverage are protected by the requirement that ILECs make all interconnection agreements available to any potential interconnector. Comments of Ameritech at 7-9. But the availability of agreements negotiated by

Second, some parties claim that national standards will eliminate the states' flexibility to address unique demographic, geographic, or other characteristics of the states' local exchange markets that would warrant deviation from the federal model. For many of the reasons described in the preceding paragraphs, these claims are unfounded. If a state wishes to establish an alternative interconnection regime that reflects unique circumstances within the state, it is free to do so and parties are free to follow the state regime in voluntary interconnection arrangements.

If a state determines that it faces unique circumstances that would make compliance with the federal regulations inconsistent with the public interest, the state has a remedy under existing law. As the Illinois Commerce Commission observed in its comments, states that face unique circumstances can seek a waiver of the federal rules.[8] Section 1.3 of the FCC's Rules empowers the Commission to grant waivers of its rules "if good cause . . . is shown."[9] The courts have interpreted this Rule to permit a waiver of the FCC's regulations if the party seeking a waiver can "demonstrate that special circumstances justify a departure from the general rule and that such a deviation will serve the public

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others protects carriers with no negotiating leverage *only if* the ILEC will be negotiating with at least one interconnector who *has* bargaining power. This condition is simply not present in current local exchange markets. In the absence of an interconnector with bargaining power, the general availability of each interconnection agreement will not ensure balanced negotiations, it simply would make a lopsided agreement available to others.

8 Comments of the Illinois Commerce Commission at 13.

9 47 C.F.R. § 1.3 (1996).

interest."[10] Thus, any state facing unique circumstances that justify deviation from federal interconnection regulations can obtain a waiver.

Finally, some parties argue that national standards eliminate the states' ability to explore new solutions and ignore years of hard work by the states who have conducted proceedings to consider the introduction of competition into local exchange markets. These claims are meritless.

Several states have led the field, and have outstripped the FCC, in the consideration of local competition issues. As Ad Hoc stated in its initial Comments, however, the time has come to learn from these efforts and reap the benefits of the experience and experiments of the States; the time for experimenting is over. Congress directed the Commission to enact national standards and to foster national competition. In doing so, the Commission will have the benefit of the work done by the states who have considered local competition issues. The FCC will be able to evaluate how different states have met their varying geographic and demographic challenges. The benefits of additional state experimentation do not outweigh the damage that would occur if local exchange competition through a federal interconnection regime is further delayed.[11]

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[10] *See Northeast Cellular Telephone Co. v. FCC,* 897 F.2d 1164 (D.C. Cir. 1990); *WAIT Radio v. FCC*, 418 F.2d 1153 (D.C. Cir. 1969).

[11] National interconnection rules have another important advantage over state standard. If the marketplace or network technologies change, a single set of national rules can be quickly and efficiently revised to accommodate the change, unlike a resource-consuming, state-by-state review.

II. NETWORK ELEMENTS

In its Comments, Ad Hoc urged the Commission to pursue an aggressive unbundling approach in order to ensure that the network element "ingredients" of the ILECs' monopoly services are available at the most granular level. The more unbundling the Commission requires, the fewer services CLECs will be forced to obtain from their ILEC competitors in order to provide their own services and the greater their opportunities will be to introduce new and innovative services that use only a subset of traditional network elements. Similarly, users, interexchange carriers ("IXCs"), system integrators, and enhanced service providers ("ESPs") will be able to obtain and pay for only the specific functionalities they require, eliminating an unnecessarily inflated revenue stream for the ILECs that could otherwise be used to cross-subsidize the ILECs' entry into competitive markets and distort the competitive playing field in the new market.

Accordingly, Ad Hoc advocated further unbundling of the basic four network elements identified in the Notice of Proposed Rulemaking ("NPRM").[12] Both MCI and AT&T described in their Comments specific unbundling proposals which further disaggregate local network functionalities. Ad Hoc supports both approaches because they advance the policy objectives described in Ad Hoc's Comments, though they differ somewhat as to specific subelements.

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[12] *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, *Notice of Proposed Rulemaking*, FCC 96-182 (1996) ("NPRM").

Several ILECs[13] claim in their comments that it is technically infeasible to unbundle local loops into the subelements identified in the NPRM and discussed by proponents of loop unbundling. Given the ubiquity of host/remote switching arrangements in local loop configurations, these claims of technical infeasibility strain credulity and should be rejected by the Commission. Standard industry technical specifications and systems already exist which make unbundling, and interconnection to unbundled loop subelements, technically feasible.[14]

Significantly, at least one ILEC has broken ranks and advocated loop subelement unbundling. Citizens Utilities Company, which provides local exchange telephone service in a number of suburban and rural areas,[15] identifies in its Comments a list of "the minimum level of required network unbundling"[16] which is "[b]ased upon its experience in both local exchange and competitive local exchange operations."[17] Citizens' list includes "2 and 4 wire local loops, as a whole, and 2 and 4 wire loop distribution facilities, loop concentration plant, and loop feeder plant."[18]

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13 *See, e.g.*, Comments of Ameritech at 36-42; Comments of Bell Atlantic at 23-24; Comments of Bell South at 39; Comments of NYNEX at 64-68; Comments of Southwestern Bell Communications at 38-40; Comments of US West at 48-54, note 109.

14 *See, e.g.*, Comments of AT&T at 19; Comments of MCI at 29.

15 Comments of Citizens Utilities Company, at 1-2.

16 *Id.* at 15.

17 *Id.*

18 *Id.*

For the reasons described in Ad Hoc's Comments, Ad Hoc also supports those commenters who advocate additional unbundling of local switching into the separate logical functionalities enabled by the physical components.[19] Many of the "value-added" services that will enable competitive local exchange carriers ("CLECs") to attract market share are derived from or require access to (or avoidance of) the ILECs' switch-based functionalities. In order to compete effectively and to pay for no more of the ILECs' services than those they use to provide their own services, CLECs will need access to unbundled functionalities and the ability to pick and choose among switching functions.

III. PRICING STANDARDS

Attached as Appendix A to this reply is a study entitled "Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market." We respectfully direct the Commission to this attachment for a more in depth response on pricing standards.

IV. AVAILABILITY OF INTERCONNECTION FEATURES AND FUNCTIONS

The Committee will not repeat the policy arguments in its initial Comments regarding the necessity for making interconnection services and unbundled network elements broadly available to entities other than CLECs. Other

[19] For example, MCI advocates that central office switch and remote switching system functionalities be unbundled into such functionalities as dialtone, screening, digit analysis, routing, testing, recordings, signal generation, call completion, etc. Comments of MCI at 30.

commenters have provided detailed analyses of the Act's provisions and its legislative history, both of which demonstrate that the duties imposed by Section 251, and the services required to discharge those duties, encompass the exchange access services prescribed by Part 69 of the Commission's Rules.

The Committee does wish to add one point after reviewing the initial comments. The Commission must soundly reject a recurring argument in the ILEC's comments regarding the meaning of Section 251(g) of the 1996 Act. Section 251(g) states that the ILECs must continue to provide access service in accordance with the restrictions and obligations established by the Commission's rules and policies "*until* such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after such date of enactment."[20] Some ILECs have argued from this language that Congress did not contemplate that the interconnection services and unbundled network elements required by Section 251 would replace the IXC-to-ILEC interconnection required by the Commission's Part 69 access rules.

The plain language of Section 251(g) clearly indicates the opposite. The section states that the existing access rules apply "until" superseded, which demonstrates that Congress contemplated that the rules will be superseded at some point in time; the issue is not *whether* but *when*. No such provision would have been required if there were no overlap between, on the one hand, the interconnection services and network elements required to discharge an ILEC's

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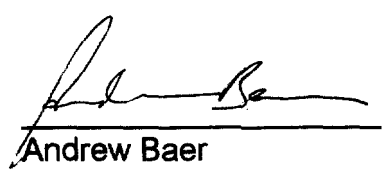
[20] 1996 Act, § 251(g) (emphasis added).

Certificate of Service

I, Andrew Baer, hereby certify that true and correct copies of the preceding Reply Comments of the Ad Hoc Telecommunications Users Committee in the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, were served this 30th day of May, 1996, via first class mail, upon the parties on the attached service list, and via hand delivery of the following:

Janice Myles*
Common Carrier Bureau
Federal Communications Commission
1919 M Street, NW.
Rm. 544
Washington, DC 20554

ITS, Inc.*
1919 M Street, NW
Suite 246
Washington, DC 20054



Andrew Baer

May 30, 1996

*By hand delivery

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duties under Section 251 and, on the other hand, the interconnection services and network elements required by Part 69 of the Commission's rules.

CONCLUSION

Because of the extraordinary and unreasonable time pressure Congress created in the 1996 Act, the Ad Hoc Committee has focused these reply comments on only the key issues discussed above. The Commission, unfortunately, will not have that luxury when it considers the entire record in this proceeding. We urge the Commission to protect the interests of users, in keeping with its statutory mandate, notwithstanding the fact that, as always, most of the comments (and pages) in this record have been submitted by carriers.

Respectfully submitted,

AD HOC TELECOMMUNICATIONS USERS COMMITTEE

By: Colleen Boothby

Economic consultants:

Susan M. Gately
Susan Baldwin
Douglas S. Williams
Economics and Technology, Inc.
One Washington Mall
Boston, Massachusetts 02108-2617
(617) 227-0900

Colleen Boothby
Laura F. H. McDonald
Levine, Blaszak, Block & Boothby
1300 Connecticut Avenue, NW
Suite 500
Washington, D.C. 20036
(202) 223-9019

Its Attorneys

May 30, 1996

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APPENDIX A

Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market

Appendix A
CC Docket No. 96-98

Susan M. Baldwin
Susan M. Gately
Douglas S. Williams

prepared for the

Ad Hoc Telecommunications Users Committee

May 30, 1996

ECONOMICS AND TECHNOLOGY, INC.
ONE WASHINGTON MALL • BOSTON, MASSACHUSETTS 02108

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Interconnection Pricing Standards for Monopoly Rate Elements in a Potentially Competitive Local Telecommunications Market

I. Introduction

This report was prepared at the request of the Ad Hoc Telecommunications Users Committee (Ad Hoc) to respond to those issues explored in the initial comments filed on May 16, 1996 in the FCC's "Interconnection" proceeding (CC Docket No. 96-98) that concern pricing standards and cost methodologies.[1] The purpose of Ad Hoc's affirmative recommendations is to assist the FCC in establishing pricing standards that can guide the implementation of the mandate of Sections 251 and 252 of the Telecommunications Act of 1996 ("the Act") in a way that minimizes administrative burden (to the extent possible), maximizes economic efficiency, and is supplier-neutral.

The discussion in this report reflects not only ETI's specific recommendations regarding interconnection, network unbundling, and mutual compensation, but also ETI's familiarity with the numerous contentious proceedings before the FCC in which incumbent local exchange carriers (ILECs) have persistently thwarted efforts by potential competitors to enter the local exchange service market. This historical intransigence of the ILECs with respect to attempts by others to enter markets that they have traditionally dominated should inform the FCC as it evaluates the recommendations of the nearly 200 commenting parties. Finally, in many instances, the flaws in the arguments that the ILECs raise in their initial comments have already been rebutted in Ad Hoc's initial comments and the appendices thereto, and are not repeated here.

1. NPRM, paras. 117 through 157.

II. ILEC claims of potential harm that would flow from the use of forward-looking TSLRIC methodology are flawed.

A. ILECs' insistence on "full" and "total" recovery of embedded costs are premised upon incorrect assumptions about the nature of those historic costs.

A frequent theme throughout the comments of the ILECs is the difference between the level of historical embedded "revenue requirement" costs and the forward-looking Total Service Long Run Incremental Cost (TSLRIC) of the interconnection services under consideration in this proceeding. Although little to no empirical support for these assertions has been provided, the ILECs claim that they must be allowed to recover historical embedded costs or dire consequences will ensue.[2] Echoing the comments of individual ILECs, USTA and Bell Atlantic, through the affidavit of Prof. Jerry A. Hausman, assert that "if all prices are set at TSLRIC or LRIC, LEC total costs will not be recovered because of fixed and common costs," including the "historical costs of network investment."[3] Hausman further argues that the recovery of ILEC historical embedded costs is required on the basis of "[p]roductive efficiency," i.e , to incent ILECs to continue to make efficient investments in their networks.[4]

Implicit in ILEC arguments relative to the need to recover historical embedded costs is the idea that much of the plant presently on the ILEC books is relatively old, expensive and obsolete, presumably acquired long ago (prior to the advent of competition). The Commission must critically examine whether any factual basis exists for this implicit assumption. Examination of such data is likely to reveal that the divergence between historical embedded costs and TSLRIC results *cannot* be explained by these factors. More likely, such empirical evidence will reveal that recent ILEC plant additions and retirements have been related to and motivated by the other more strategic goals of the ILECs. As such, the ILECs have no "entitlement" to the recovery of these revenues from monopoly interconnections services.

USTA and Bell Atlantic's Hausman asserts that "[p]roductive efficiency requires that embedded costs of efficient investment in the network be recovered by the LECs."[5] The

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2. See, e.g., SBC Communications Comments at 89; Bell Atlantic Comments at 36; BellSouth Comments at 57; Ameritech Comments at 68-70.

3. Affidavit of Jerry A. Hausman. Professor Hausman's Affidavit was appended to the Comments of both Bell Atlantic and USTA, and is representative of the positions argued by many of the ILECs in this proceeding.

4. *Id.*, para. 3.

5. *Id.*, para. 3.

apparent rationale for this curious view (curious because it is at odds with fundamental economic theory) appears to be his contention that "federal and state regulatory distortions, and subsidization of services created to serve regulatory policy objectives ... [make it] inappropriate regulatory policy and incorrect economics to price interconnection at TSLRIC or LRIC ..."[6] The operative phrase here, however, is "*efficient investment in the network.*" The "regulatory distortions" and "subsidization" referred to under this thesis, work to create a "regulatory bargain" in which ILECs are induced to make "efficient investments" in return for an expectation of recovery and reasonable return both due to and despite pricing and other constraints imposed by regulators. The implication is that the investment would not have been made at all under competitive conditions where no expectation of recovery and return would have been assured. However, this "efficient investment in the network" standard is not satisfied as a factual matter by most ILECs.

Another (perhaps more charitable) interpretation of Hausman's thesis is that ILECs won't invest in the network if the rules are changed in the middle of the game. If (as he would appear to suggest) ILECs invested with an expectation of full recovery and *subsequent to that investment* regulators expressly preclude ILECs from pricing to recover embedded costs, ILECs (presumably) won't be able to trust regulators to allow recovery of investments in the future. However, failure of current prices to recover *past* sunk investments in no way limits *forward-looking prices* from being set to fully recover *forward-looking costs*. And both productivity and allocative efficiency is best assured when prices are set on the basis of forward-looking incremental cost and not (as Hausman now claims) to recover sunk costs that *by definition* will *not* be incurred by the ILECs on a forward-looking basis.

Even with respect to the recent changes in the traditional regulatory paradigm of protected monopoly and the expectation by ILECs of their ability to fully recover and earn a reasonable return on their investments, ILECs cannot reasonably claim that such revisions have been either precipitous or unanticipated. In addition to the tradition of nearly three decades of FCC policy initiatives leading toward the achievement of a more competitive telecommunications marketplace, ILECs themselves — and particularly the RBOCs and GTE — in promoting the enactment of the *Telecommunications Act of 1996* expressly agreed to and accepted the removal of economic and legal entry barriers — including a commitment to provide new entrants with unbundled interconnection *at cost-based rates* to ILEC networks and network resources — as a *quid pro quo* for their own entry into the interLATA (long distance) marketplace.

Indeed, examination of the empirical evidence should reveal that the majority of ILEC embedded net investment is not the result of protracted network development over decades of operating under the traditional "regulatory bargain," but rather consists of assets *recently*

6. *Id.*, para. 4.

acquired with full knowledge and understanding of the regulatory and competitive changes that were then ongoing. Based upon our understanding of the rate of RBOC investment in plant and facilities it appears likely that well over half of the RBOC net rate base on these companies' books at the present time has been put in place since the start of 1990. Moreover, a large portion of the pre-1990 net plant that remains on RBOC books is for the type of assets for which current reproduction costs for similar plant still being acquired are greater than the original acquisition cost of such assets. It is likely that only a small fraction of the post-1990 gross plant additions in switching and outside plant distribution facilities would constitute "efficient investment in the network" that has been driven by any traditional "franchise obligation" or "carrier of last resort" requirement that may have been explicitly or implicitly imposed upon ILECs even under the traditional pre-competition "regulatory bargain."

Thus, while Hausman seeks to argue that ILECs are entitled to recover the embedded costs of "efficient investment in the network," there is no factual support for his leap of faith that all ILEC embedded investments are by definition "efficient." For Hausman's embedded cost pricing theory (as he has constructed it) to have any economic merit (notwithstanding its lack of theoretical or empirical support), it requires that all ILEC investments be both "efficient" and that they have been made pursuant to an expectation of full recovery pursuant to a traditional regulatory bargain. Neither of these conditions exist as a matter of fact, as would be borne out by a detailed examination of the ILECs' asset base and investment practices over the past several years.

In fact, ILEC investments in recent years have been motivated not by any carrier of last resort obligation but rather by the incumbents' desire to position themselves strategically and competitively for the very same market and regulatory climate that the ILECs suggest be ignored. Indeed, to the extent that sunk embedded costs exceed forward-looking TSLRIC, no provider — incumbent or new entrant — could have any expectation of their recovery in the long run under competitive market conditions. In competitive markets, prices cannot be set to recover previously-incurred costs if current and prospective costs are lower. Only firms with market power sufficient to permit dictation of prices can have such an expectation. Efficient firms make capital investment decisions in consideration of, among other things, their expectations as to future changes in the costs of the plant and as to its economic/technological life. That prices of digital central office switches are declining rapidly is relevant to each switch acquisition decision. That this equipment may reach technological and/or economic obsolescence within a few short years is also relevant in the same manner. These considerations properly influence both the decision to acquire plant as well as the number of years over which such plant, once acquired, will be depreciated. These are not "after-the-fact" considerations for an efficient firm. In competitive markets, when a firm mis-assesses the technological life of an asset, or misjudges the pace at which the prices and/or capabilities/capacities of such assets are changing, it will make *inefficient* investment choices and plant replacement decisions. If through exercise of market power (and condoned by the regulatory construct that Hausman

would impose) the ILEC continues to be assured of investment recovery *no matter how its embedded plant came to be acquired or what it consists of*, inefficient ILEC behavior is both encouraged and protected.

Incredibly, Hausman posits that ILECs will have no incentive to invest in their networks *unless they can be assured of the ability to recover embedded costs*[7] — which is another way of saying that the ILECs won't invest *unless they can assured recovery even if such investments are inefficient.* The ability of an ILEC to recover sunk, historical costs *on a forward-looking basis* will influence the ILEC's decision to commit new investment capital to its network *only if the incremental (forward-looking) revenues to be derived from such new investment are themselves insufficient to fully recover the forward-looking investment costs.* But if prices are set at a level that is sufficient to recover forward-looking costs including a reasonable profit, the presence or absence of historically-incurred sunk investments is irrelevant to any present incentives. The only condition under which an ILEC would choose not to invest for the future is where the forward-looking prices of the services to be derived from such future investment will not permit full investment recovery including reasonable profit. This condition might arise if prices are set at a level that is not sufficient to permit recovery of forward-looking non-volume-sensitive costs that are shared among two or more individual services. But if incremental revenues in toto exceed incremental costs, investment in new plant is stimulated *even where sunk costs are not or cannot be fully recovered.*

The notion that the inability of an ILEC to recover embedded costs will reduce or eliminate its incentive to make future investments rests upon two suppositions neither of which are consistent with prevailing regulatory policy and expectations:

- *First*, by proposing that unbundled rates include recovery of historic costs, Hausman is conceding that ILECs possess market power sufficient to permit such pricing to be implemented (irrespective of any affirmative regulatory authority to do so). In competitive markets, incumbent firms cannot price to recover sunk costs, *because new entrants not burdened by such costs will easily underprice the incumbent* based solely upon the forward-looking costs that the new entrant will incur in the future. Hence, the theoretical *ability* of an ILEC to set its rates to recover embedded costs *requires* that no effective competition be present in the relevant market.

- *Second*, by suggesting that the only way in which network investment will occur is under the condition that the ILEC be capable of recovering its embedded costs, Hausman reveals his apparent expectation that no such investment could take place

7. *Id.*, para. 3.

under competitive market conditions, since the presence of such competition would necessarily preclude recovery of embedded costs by any incumbent.

But the *Telecommunications Act* in providing for the eventual removal of the various MFJ line-of-business restrictions clearly does not share Hausman's pessimism both as to the development of a competitive local services market *and* the efficacy of competition in stimulating investment in the US telecommunications infrastructure. If competition in the local services market does develop to a point where ILECs no longer control essential facilities, then ILECs will no longer be economically capable of setting rates sufficient to recover embedded costs *even if otherwise authorized by regulators to do so*. Under the scenario envisioned by Hausman, such a development would produce a classic Catch-22 wherein further network investment would then cease as soon as effective competition arrives, which in turn would make the market less competitive, allowing ILECs to once again increase their prices (to embedded cost levels) and once again commence making new network investments under less-than-competitive conditions. Such a vision is at odds with the foundations and directions of modern US telecommunications policy and serves only to underscore the importance and reasonableness of setting rates for unbundled network elements at their *properly defined*[8] TSLRIC.

B. An interconnection pricing standard based on TSLRIC is not tantamount to "confiscation" as argued by some ILECs.

A number of ILECs contend that the opportunity to recover historical costs is required and allege confiscation if the FCC does not allow ILECs to earn sufficient profits to recover their joint and common costs.[9] As stated in the Ad Hoc Committee's initial comments and discussed in more detail below, prices should be set to recover TSLRIC and appropriate forward-looking joint and common costs.[10] The "confiscation" argument is premised upon the notion that the advent of competition will leave the ILECs with "stranded investment," the cost of which they will not be able to recover on a forward-looking basis.

The "stranded investment" argument has been raised in numerous state proceedings on universal service and on local competition. The FCC must address this spurious issue head-on and reject the ILECs' transparent attempt to shield their revenue stream from the competition that they have expressly agreed to accept in exchange for interLATA entry and

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8. As discussed below, a "properly defined" TSLRIC may include an appropriate, competitively neutral apportionment of shared (joint) and common costs.

9. See, *e.g.* PacBell at 66 - 67, citing *Hope Natural Gas* and *Permian Basin Rate Cases* and Bell Atlantic at 37-38 citing *Duquesne Light*.

10. As discussed more below, this recommendation does not, however, endorse a pre-approval of all joint costs.

other line-of-business and regulatory relief. There are a number of reasons why the issue of recovery of the costs of so-called stranded investment has absolutely no relevance to pricing interconnection, network unbundling, co-location and reciprocal compensation rate elements:

- *There is no "stranded investment" as an economic matter.* That the economic value of *individual* components of the ILECs' infrastructure may have fallen below book value is basically irrelevant if the *aggregation* of all LEC rate base assets continues to possess an economic value in excess of net book value, which is indisputably the case. The equity securities of each of the seven regional Bell Holding Companies are trading well in excess of book value, and since the break-up of the former Bell System in 1984, the market-to-book value ratios for each of the seven RBHCs has been steadily growing. Hence the "regulatory bargain" has been fully and indisputably satisfied: ILECs and ILEC shareholders have not been denied the ability to recover and to earn a fair return on their investment.[11]

- *ILEC management bears full responsibility for any excess plant capacity.* It should not be assumed that any observed underutilization of ILEC plant is attributable to the entry of competing carriers as opposed to other causes, such as overbuilding by the ILEC itself, linked to competitive strategies of the ILEC or simply mis-forecasting of its plant requirements and/or of the nature and rate of technological change and price movements in the telecommunications equipment markets.[12]

- *The onset of local competition was a reasonable expectation, and should have been reflected in ILEC construction planning.* Competition has been an evolving focus of US telecommunications policy for nearly three decades. It is reasonable for regulators to expect that ILECs would adjust for the onset of competition, including the possibility of loss in market share, in their construction programs.

- *Any competitive losses will be sufficiently gradual as to afford ILECs an ample opportunity to make any necessary adjustments to their cost structure.* Experience in the interstate long distance market shows that the erosion of the incumbent monopoly provider's market share will be gradual, not rapid and disruptive as the ILECs suggest. In fact, ILEC local market share erosion is likely to occur far more slowly than that experienced by AT&T,[13] due, among other reasons, to the fact that customers electing to switch from the incumbent LEC to another facilities-based provider will be required to undergo a *physical installation* of the new entrant's services at their homes or businesses. During the period 1984-1994,

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11. See Ad Hoc Initial Comments, Appendix A.

12. See Ad Hoc Initial Comments, Appendix B.

13. See Ad Hoc Initial Comments, Appendix C and Appendix D.