Expense) be apportioned among the operations on the basis of the separations of investments in the COE Accounts (2210, 2220 and 2230) combined. This separation causes a mismatch to the extent that the aggregate investment is apportioned to the interstate jurisdiction differently than the investment which causes the expenses. A similar misallocation occurs when apportioning these costs in the Part 69 process. These costs are assigned to the rate elements based on the aggregate COE investment and not by the investment which causes the maintenance expense. This results in a portion of COE maintenance expenses for local and operator switches being allocated to Common Line, Transport and Special Access where there is no switch investment to maintain. This non-cost causative approach of the assignment of these costs results in a higher TIC. U S WEST estimates this over assignment causes a $4 million impact on the TIC.

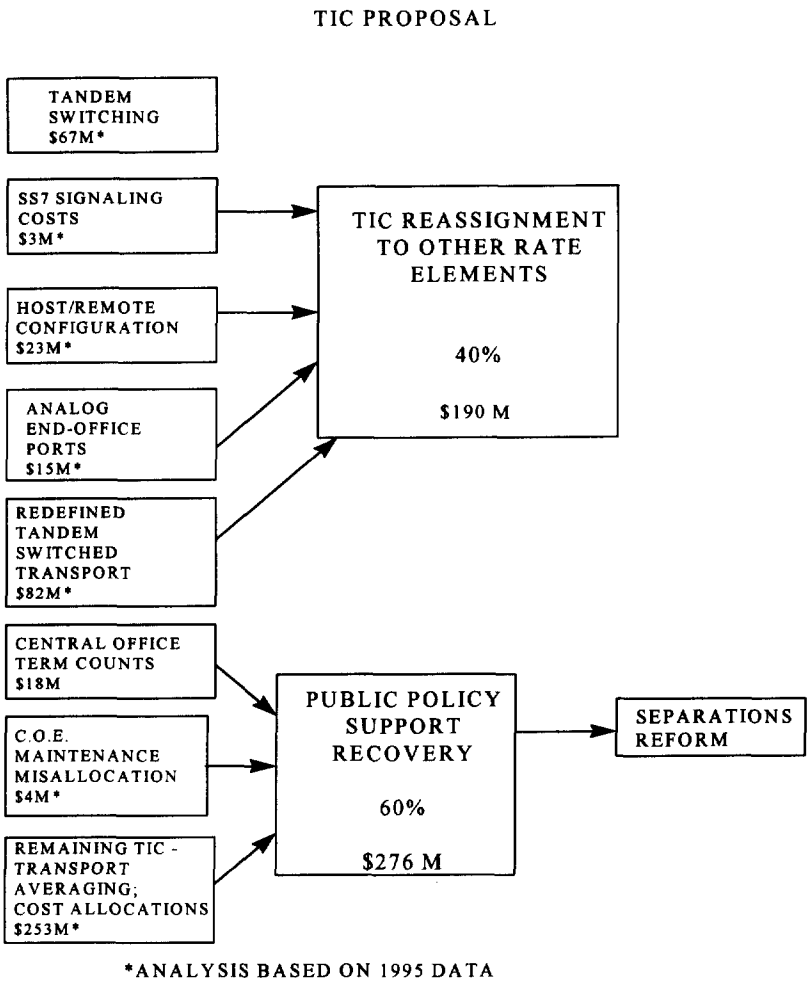
The Part 36 revisions required to implement these changes will require Joint Board action. Therefore, there will likely be a lag in implementing the necessary changes to the rules. Until the conclusion of the required separations reform, these specific TIC components should be removed from the per-MOU TIC rate and recovered instead via a support funding mechanism using interstate access minutes purchased from U S WEST to allocate the flat-rate recovery amounts. These revenues would continue to be classified as transport.

c. TIC Component Resulting From Transport Averaging, Cost Allocation And Cost Recovery

An additional component of the TIC can also be identified. Circuit equipment and cable and wire facilities serving longer haul traffic have an embedded Part 36

cost that is many times the cost developed using the special access costing methodology. The cost of hauling traffic to scattered local dial switches in remotely populated areas is several times more than the costs of hauling an equivalent unit of traffic in the larger cities as special access costs. This cost differential has been averaged over the rate charged to all customers as part of the TIC. Most of the longer haul traffic is carried on these interexchange facilities as defined in Part 36. The costs associated with this traffic are defined by the Commission's rules and are associated with the Part 69 transport element. These costs are well documented in the ARMIS process. The cost per unit of traffic using interexchange facilities is significantly higher than the cost per unit of traffic hauled over exchange, more urban type of facilities. This cost differential per unit of traffic is also part of the TIC. U S WEST estimates that the costs associated with transport to the rural areas is most of the remaining TIC amount of $254 million. These costs should be removed from the per-MOU TIC rate and recovered instead via an interstate support funding mechanism using minutes purchased from U S WEST to allocate the flat-rate recovery amounts. These revenues would continue to be classified as transport.

d. SLC Transition To Replace TIC Support



The funding mechanism which will address the TIC components which cannot be reassigned until the completion of separations change would be utilized to also address the remaining portion of the TIC. As the ultimate recovery of this portion of the TIC will likely involve Joint Board action and transference of the support from the interstate jurisdiction to the intrastate jurisdiction, a logical transition plan would include a phase-up of the end-user common line charge with a

corresponding phase-down of the support being provided by the fund. Upon the conclusion of separations reform, the increased end-user charge could be replaced with the appropriate increase in local rates.

e. Support Fund

The revenue associated with the TIC components which cannot be reassigned without separations changes (including the component relating to rate averaging and historical support) must be fully recovered through the implementation of a new funding mechanism. U S WEST proposes that this support mechanism be funded by IXCs through a flat-rate charge based on relative percentage of switched access MOU, with each carrier's share of the total amount recalculated yearly. An allocation based on usage reflects the benefit the carrier derives from use of the public switched network. Also, this allocation assigns the support to the same companies who are obligated to fund this implicit support today, is simple to implement, and easy to administer.

f. TIC Price Cap Formula Changes

As stated above, the remainder of the TIC results from transport averaging, cost allocations, and cost recovery. These costs are not only on-going, but also increasing, as the ILEC continues to invest capital to provide new service. The current mechanism reduces the MOU rate by the percentage change of the PCI. However, the LEC recovers the increasing costs, assigned to the TIC, through the growth in MOU. With the recommendation of a flat-rate recovery mechanism based on relative percentage of switched access MOU, U S WEST is concerned that the

increasing costs assigned to the TIC will not be recovered in total. U S WEST recommends the following formula to calculate the TIC flat-rated charge.

$TIC_t = TIC_{(t-1)} * \Delta PCI * (1+(mou_t / mou_{(t-1)}))$

TIC_t = Proposed TIC Bulk Bill amount
$TIC_{(t-1)}$ = Current TIC Bulk Bill Amount
mou_t = Current mou
$mou_{(t-1)}$ = Previous year mou

This will ensure the full recovery of transport averaging, cost allocations and historical support until the Commission transitions these cost to the end user common line charge.

D. SS7 Signaling (¶¶123-138)

The Commission also seeks comment on whether it should revise the SS7 rate structure.[64] Specifically, the Commission questions whether Ameritech's restructuring of SS7 costs, granted pursuant to waiver, should be used as a model for the whole industry.[65] While U S WEST believes that Ameritech's proposal for the pricing of SS7 is feasible, we do not believe that such a structure should be mandated. The pricing of SS7 should be left to the individual supplier in order to meet cost recovery and ensure pricing flexibility to promote competition.

Specifically, U S WEST views the current proposal as follows:

Signal Link This rate element could be implemented and should remain in the current rate categories basket.

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[64] Notice ¶ 127.

[65] Id.

STP Port Termination U S WEST believes that there is a fixed cost per port and that flat rating is appropriate. U S WEST views the port as a competitive piece. The customer does have options in provisioning. This element should remain in the same category and new price caps are not appropriate.

Signal Transport U S WEST agrees that queries are associated with two-way links and should be message based. U S WEST proposes that rating be by length of signaling message rather than distance of route.

Signal Switching This function should be rated on a per-query basis and should also be based on the complexity of routing and screening. Peak load pricing is not an option as "peak" is not a common element for the customers serviced by U S WEST. New categories are not appropriate.

E. Price Cap Regulation (¶¶ 231-235)

In addition to the Rate Structure Modifications the Commission is seeking to change in this proceeding, the Commission should also consider modifying the Price Cap Basket structure in Part 61 of the Commission's rules. The emerging marketplace no longer need the constraints of multiple Price Cap baskets as a surrogate for competition. The one basket proposal by the United States Telephone Association in this proceeding should be adopted by the Commission. This proposal requires only one basket with four service categories, Tandem Switching and Transport, Local Switching, Database Services, and Common Line. Each Service category can have multiple zones.

U S WEST proposes that the upper pricing constraint be the PCI for the basket, i.e., the Actual Price Index is equal to or lower than the PCI. Pricing

constraints at the service category level are not necessary because the presence of unbundled network elements and competitive carriers offer alternatives for the customer, previously unavailable them. The presence of alternatives will dissuade LECs from increasing rates that encourage competitive carriers to enter markets that previously were unattractive to competition.

V. UNTIL THE ILECS ARE TOTALLY DEREGULATED AT BOTH THE STATE AND FEDERAL LEVEL, ANY TRANSITION PLAN IMPLEMENTED BY THE COMMISSION MUST ENSURE THAT ILECS ARE GIVEN A REASONABLE OPPORTUNITY TO RECOVER THE COSTS RELATED TO THEIR EMBEDDED INVESTMENT (¶¶241-270)

The Commission and its state counterparts have been put in an unenviable position. The 1996 Act, as implemented by the Interconnection Order, has placed the existing pricing scheme for all ILEC services under great stress.[66] Specifically, the availability of unbundled network elements at economic cost significantly jeopardizes the ability of the ILECs to recover embedded costs allocated to the interstate jurisdiction by the separations process and to recover their depreciation reserve deficiencies. Yet, the Commission and the state commissions have a Constitutional obligation to give the ILECs an opportunity to recover these costs.

Managing the transition to full deregulation of the ILECs -- which must be the ultimate goal of the transition -- will be difficult, as the commissions juggle their statutory mandate to bring competition to all segments of the industry against their Constitutional obligation to afford the ILECs an opportunity to earn on their embedded investment and to recover that investment.

[66] Exhibit 1 at 30-36.

In the Introduction to these Comments (section I.A., supra.), we discussed the problems created by dissonance between the ILECs' obligation to provide unbundled network elements at prices based on forward-looking economic costs and the devices state and federal regulators have used to keep local rates as low as possible.

Specifically, the separations process has allocated more cost to the interstate jurisdiction than is economically justified, and regulators have required the ILECs to utilize depreciation lives for their plant and equipment far longer than the economic lives that would be used by competitive firms. These practices were sustainable in a monopoly environment: interstate services could subsidize local service; future customers could subsidize current customers. The availability of unbundled network elements priced at economic cost requires an end to these subsidies, as the Commission has recognized.

But the advent of interconnection has not done away with the costs the subsidies defray. Those costs arise from real facilities, for which the ILECs invested real money -- and for which they must get a real return. As we noted in the Introduction, so long as the government requires the ILECs to allow others to use their property at rates limited by the government, it has an absolute Constitutional obligation to give the ILECs an opportunity to earn a reasonable return on that investment and ultimately to recover that investment. The government cannot require an ILEC to operate at a loss.

In designing a transition to move the industry to competition the Commission must remain mindful of these requirements.

Though deregulating access charges is an essential result of any transition, by itself it will not resolve these problems. As the access charges imposed on IXCs come down, the revenues lost must be replaced by charges on end users: if access charges are priced above economic cost, the rates for residential local exchange service are priced below economic cost. Indeed, U S WEST's studies indicate that pricing residential local exchange service at TSLRIC would generate more than $2 billion in additional revenue. If the charges for the subsidizing service (access) are reduced, the ILECs must have the ability to increase the charges for the subsidized service (residential local exchange service).

In working their way through this dilemma, regulators must take care not to trample the very competition they hope to spawn. We will explain below that some sort of bulk-billed charge, imposed on some or all segments of the industry, is the only viable means of enabling the ILECs to recover the costs associated with their embedded investment. That charge, however, need not simply be the difference between the costs assigned to the interstate jurisdiction through separations (embedded costs) and the revenues that might be generated by retail prices equal to TELRIC (assuming the regulators allow the market to determine price, rather than prescribing rates equal to TELRIC). Rather, the bulk bill charge should reflect the difference between these embedded costs and the prices permitted by the market at any given time.

If the regulators force the ILECs to set their retail prices at TELRIC, but grant them recovery of their embedded costs through some sort of bulk-billed mechanism, the ILECs' local competitors will have no chance in the market because

they will not be able to recover their costs. Nor, given their Constitutional obligations, can the regulators limit the ILECs' retail prices to TELRIC while denying them the shortfall between those rates and their embedded costs.

The answer is that the regulators must give the ILECs incentives to price their retail services to the market, bringing them down toward TELRIC only as market forces dictate.[67] ILECs have a right to expect the regulators to give them a fair chance to compete at a fair market price. That doesn't mean they will not lose market share, they will. It means they will have an opportunity to recover their investment. The ILEC should be able to price to the market, but not below it. Thus, as long as the ILECs recover certain embedded costs by means of a bulk-billed transition charge on the IXCs, the regulators need to be more concerned that the ILECs' retail rates are too low, rather than that they are too high. If ILECs' do act in an anticompetitive manner which threatens a competitive market the Commission has ample authority to intervene to prevent such behavior.

At an abstract level, calculating the transition costs is a simple matter: they are the difference between an ILEC's interstate revenue requirement and the amount the ILEC would recover from access charges set at economic cost. The difference derives principally from separations misallocations, and the depreciation reserve deficiency.

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[67] This means unbundled elements must be priced above TELRIC (see 1.A.3). Since ILECs cannot price access services above the price of unbundled elements because they are direct substitutes pricing unbundled elements at TLERIC, therefore dictates that access be priced at TELRIC and local competitors will only be competitive if they purchase unbundled elements rather than construct alternative networks.

A. Separations Misallocations

The jurisdictional separations process as it exists today cannot continue when customers can purchase identical services at different prices outside the separations process (that is, at prices set without regard to separations, as with unbundled network elements). Until the Federal-state Joint Board can harmonize the separations process with the new world of interconnection and rates are re-balanced, the Commission must devise a regulatory regime that allows for recovery of the real costs of the ILECs that have been allocated to the federal jurisdiction by the separations process.

Today's separations rules were devised over the last 60 years based on political compromise and an objective of maintaining low basic telephone rates. Both federal and state regulators have, however, always recognized the ILECs' right to recover their prudently incurred embedded costs. These political compromises have produced a system that frequently allocates embedded costs in arbitrary ways, rather than on the basis of economic costs. For example, 25% of local loop costs are currently allocated to the federal jurisdiction, yet interstate calls represent only about 15% of local loop traffic. Given that an ILEC can recover its interstate costs only from its interstate customers, the ILECs are at an instant disadvantage when competing with purchasers of unbundled elements, who have many more options to recover their costs.

The above discussion highlights an important point that must inform the Commission's choice of access reform proposals. The arbitrage opportunities created by the Interconnection Order have nothing to do with inefficiencies. Those

opportunities result from 60 years of state/federal policy decisions on how to allocate recovery of the ILEC's embedded costs. Until both federal and state regulators eliminate these arbitrary rules, the Commission must devise a recovery mechanism for these prudently-incurred costs that have been allocated to the federal jurisdiction.

U S WEST recognizes that revisions to the separation rules cannot occur overnight. The Commission, however, has an opportunity in this proceeding to take the lead by reallocating these costs within the federal jurisdiction until separations reform can be implemented. The Commission should first allow the ILECs to recover embedded costs that are inappropriately (i.e., uneconomically) allocated to the federal jurisdiction by means of a bulk bill to the IXCs. This will immediately solve the arbitrage problem created by the Commission's interconnection rules.

Because these costs relate predominantly to the local loop, the second step should be to transition them from the bulk bill to the EUCL charge over a three-year period, to coincide with the completion of separations reform. Such a two-step process will enable the Commission to shift the recovery of these embedded loop costs to end users, which is entirely appropriate and economically correct.

The Commission has an obligation to the ILECs to give them a meaningful opportunity to recover their prudently-incurred, interstate-allocated, embedded costs. These costs are the result of investments made by the ILECs to acquire facilities. Others use that property to obtain telecommunications services at rates that are limited by the state and federal regulatory commissions.

So long as the regulators prescribe the charges that the ILECs may impose for the use of the property, they have a Constitutional obligation to allow the ILECs an opportunity to earn a reasonable return on their investment in that property and ultimately to recover that investment.

B. Depreciation Reserve Deficiency

In addition to allowing the use of economic lives in forward-looking cost studies, the Commission must also establish a mechanism to address the significant reserve deficiency that has been created by the use of uneconomic depreciation lives in the past. A reserve deficiency is the difference between the amount of accumulated depreciation actually recorded on a company's books and the amount that should have been recorded if economic lives has been the basis for depreciation entries all along, as shown in the following example:

Assumptions:

	Historical	Future
Asset life	15 years	10 years
Current age of asset	5 years	5 years
Asset value	$1500	$1500
Annual depreciation	$100	$150
Accumulated depreciation	$500	$750
Remaining depreciation	$1000	$750
Reserve deficiency	$250	

This example shows that after five years using historical regulatory lives this hypothetical asset will be under-depreciated by $250 or 50%. If an ILEC converts to

economic lives, this $250 will never be recovered unless a mechanism such as RDA is established to recover the under-depreciation.

Solely adopting the economic lives discussed previously (section I.A., supra.) does nothing to address this deficiency. The use of economic lives will ensure that depreciation going forward is at an appropriate level, but it does not address past under-recovery. As a part of access reform the reserve deficiency must be addressed to provide a transition to a more fully competitive marketplace. U S WEST has prudently invested capital in the past to serve customers and must be allowed an opportunity to recover this investment. In a competitive marketplace, failure to address the deficiency will lead to a loss of opportunity for investors to recover their prudently invested capital. Given the size of the deficiency, this is a significant concern. Because of the depreciation lives prescribed in the past, U S WEST's currently interstate reserve deficiency equals $466 million.[68]

The solution to this under-recovery of existing investment is to include it in the bulk bill proposed by U S WEST and amortize it over three years. This is the best solution because the bulk bill will be paid by the IXCs who have benefited from the under-depreciation. These amounts represent real costs derived from real assets for which the ILECs invested real money. If state and federal regulators had allowed the ILECs to price their services using economic depreciation lives, these

[68] It should be noted that for the copper cable accounts, this reserve deficiency has been calculated using somewhat longer lives than in the cost studies. Such treatment reflects the fact that copper cable is a dying technology and recognizes the differences in expected lives for today's embedded investment versus the lives of new investment being placed in the future.

costs would have been recovered in the past. If, on the other hand, local service had remained a monopoly, the ILECs could recover them in the future. Because we have neither situation, the ILECs must recover these amounts during a short transition period, else they will never have an opportunity to do so.

VI. THE ESP EXEMPTION MUST BE ELIMINATED (¶¶ 282-290)

The Notice initiates a Notice of Inquiry on the existing ESP exemption from switched access charges, but does not propose to do anything about this exemption in the docket itself. U S WEST will comment in the Notice of Inquiry which the Notice establishes. Nevertheless, it is disappointing that the Commission seems again to be ducking resolution of an issue which has been crying out for resolution for more than a decade. Because the ESP exemption creates a subsidy to certain interstate suppliers of telecommunications services at the expense of others, it is inconsistent with the 1996 Act and must be eliminated. Moreover, the exploding growth of Internet usage and Internet access turns this subsidy issue into one of immediate and critical importance.

The fact that the ESP exemption provides an unlawful implicit subsidy is a fundamental principle which must be understood. ESPs, because they are treated as end users, not carriers (the distinguishing characteristic for deciding who pays carrier's carrier charges), pay only local rates for their use of local exchange services. ESPs receive traffic through local exchange switches but further route the traffic via private lines (special access). ESPs accordingly use local exchange switching facilities to originate and terminate interstate traffic. However, unless they pay the special access surcharge (which few do), the only payment which they

make for this interstate usage of local exchange switching facilities is payment of the SLC on their loops. When ESPs collocate in the POP of an IXC, they do not even pay an interstate special access charge. Because most ESPs purchase service from ILECs which is almost entirely terminating, they can even avoid paying a fair local rate (by purchasing measured service, which is measured originating only, ESPs can pay an extremely low flat rate for local service).

The access charge structure is set up so that carriers cannot avoid paying these interstate charges when they use local exchange switching facilities for the identical interstate purpose as are used by ESPs. Carriers, by paying higher charges for access, are thereby subsidizing ESPs, an implicit subsidy which is prohibited under the 1996 Act. Perhaps more significantly, by discriminating against carriers and in favor of ESPs, the Commission is creating economic incentives which will lead inevitably to market dislocations based on these incentives.

The first (and most clearly predictable) of these dislocations will occur in the area of entities seeking to avoid carrier status in order to enjoy the benefits of the ESP exemption. Entities should be able to design their services to meet business and market needs, not to meet the exigencies of a regulatory quirk.

The second dislocation has already begun to manifest itself. If ESPs are end users, and all traffic going to an ESP is terminating traffic, the reciprocal compensation rules established by the Commission offer enormous potential for arbitrage and abuse. For example, a carrier (a CLEC) could set itself up to serve only ESPs. It would be able to order interconnection services from another LEC

which were entirely terminating in nature (because all traffic "terminated" at the "premises" of the ESP, even if the ESP were collocated with the CLEC). Under these circumstances the carrier serving the ESP would receive a one-way revenue flow from the LECs delivering traffic to it. Such a development would exacerbate the already serious economic effects which the ESP exemption has on LECs.

We do not suggest that the solution to the ESP exemption problem is simple --although it would have been considerably easier to fix ten years ago, and it will be impossible to fix if permitted to go on much longer. Nor do we suggest that the Commission should flash-cut ESPs to the payment of full switched access rates whenever they use local exchange switching facilities to originate or terminate interstate traffic. A reasonable and certain transition would be appropriate to coincide with access reform. However, the Commission should not put off recognizing the essential anomaly of the ESP exemption and the necessity of fixing it on a timely basis to yet another proceeding.

Respectfully submitted,

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EXHIBIT 1

A. INTRODUCTION AND EXECUTIVE SUMMARY

The ultimate goal of the Telecommunications Act of 1996 is to ensure a wide range of high quality, low-cost, readily available, technically advanced telecommunications services for American consumers, business enterprises, schools, hospitals, government agencies and non-profit organizations. This goal can only be achieved by promoting investment and continuous technological progress in the nation's communications infrastructure: it can not be achieved merely by allowing competitors to buy existing network facilities on an unbundled basis or by reselling existing services bought from local exchange carriers on a wholesale basis. It is therefore imperative that the Commission adopt rules in this proceeding that promote efficient competition; facilitate the innovation, deployment and adoption of new technologies and services; and provide adequate incentives for expanding investment in the nation's telecommunications and information infrastructure. Conversely, it would be directly contrary to these policy objectives for the Commission to adopt policies that encourage inefficient entry, distort the competitive process by creating or enlarging artificial advantages of some competitors, or reduce the incentives for innovation and investment by incumbent and potential new service providers.

The appropriate policies for the transition to full competition should recognize the important role that U S WEST and other LECs will continue to play in that transition. Over the past decade, investments by local exchange carriers have been essential to the development of competition in interexchange services. For example, without substantial investments in improved switching capabilities, there would have been no "equal access" for IXCs. To promote equal access, this Commission specifically adopted policies that provided the stream of revenues required to fund those investments. The Commission should not adopt policies requiring enormous investments by LECs, without ensuring the recovery of the revenues needed to cover the costs of those investments. For an interim period of several years, U S WEST and other LECs will provide key ingredients to the "network of networks," including a means of interconnection and interoperability across the rapidly growing number of competing and

cooperating communications networks. Provision of these ingredients and continued investments in the existing public telecommunications network will require enormous expenditures. Thus, it is crucial to the nation's interest in the communications infrastructure and in competition that U S WEST be allowed to compete on even terms.

As a matter of first principle, then, the Commission's rules should promote allocative, technical and dynamic efficiency. At all costs, the Commission should avoid policies that may create the appearance of competition – e.g., by increasing the number of competitors in local exchange services – but that, in the long run, actually inhibit real competition by creating conditions that ensure the success of a few large firms at the expense of many other potential competitors. Given the history of this industry, it is especially important that the Commission's rules do not recreate an industry in which one firm, such as AT&T, is allowed to dominate the marketplace. Yet, if the Commission were to adopt the policies advocated by AT&T, that would surely be the result. For example, if the Commission mandates that incumbents set the wholesale price of local exchange service below its full economic cost, as AT&T proposes, it runs the very real risk of creating an environment in which AT&T will dominate local exchange markets. Instead, the Commission should pay careful attention to the likely effects of its rules on the structure of future local exchange and other telecommunications markets, as these markets will be powerfully influenced by the results of this proceeding.

It is critically important that the FCC's rules not distort competitive dynamics by favoring one class of competitor or one type of technology over others. With business units operating as (1) an incumbent LEC, (2) facilities-based new entrants (i.e., its cable companies), and (3) a wireless service provider in different jurisdictions, U S WEST has a particularly strong incentive to favor balanced competition so that its individual constituents can compete for local exchange business on their respective merits. Hence, U S WEST opposes policies that are biased in favor of either incumbents or entrants. A significant danger is that policies will be biased in favor of entrants, i.e., policies that promote "biased competition," but inhibit the development of efficient competition. To take one historical example, in surface freight transportation, regulatory policies

greatly inhibited railroads from competing with motor carriers. Those policies caused enormous inefficiencies and competitive distortions and literally drove many railroads into the ground. Only when many rail carriers were in bankruptcy did Congress and the Interstate Commerce Commission finally free the railroads from regulatory policies that had prevented them from competing with other modes of transportation. We certainly hope that the nation does not follow a similar path in telecommunications.

The Commission can increase the probability of success in local exchange competition by adopting the minimal set of rules necessary to ensure nondiscriminatory interconnection to the public switched network. Public policy remedies should be narrowly tailored to ameliorate the underlying economic problem they intend to address. The approach of tailoring the remedy to the problem is applied in antitrust and consumer protection law and policy, thereby avoiding unanticipated distortions in the market. By limiting its rules to those required to establish conditions that will allow fair competition to flourish for the benefit of consumers, the Commission will enable an expansion of voluntary choices based on buyers and sellers negotiating and transacting in markets, rather than on regulatory imperatives and restrictions.

In so doing, the Commission should recall the central role of prices in a market economy. If the prices of telecommunications services – whether at the retail or wholesale level, of unbundled or bundled services – do not cover their full economic costs, neither incumbent LECs nor existing competitors nor potential new entrants will have ANY incentive to invest in network facilities. It is well understood that competition promotes efficiency by driving prices toward costs; it is worth noting, though, that efficient competition will not develop and cannot succeed if some firms are required to sell outputs at prices that are below cost. Thus, whatever rules are adopted to determine wholesale, network element and interconnection prices, it is imperative that those prices be based on the full economic costs associated with providing each service. Economically incorrect pricing will reduce or distort investment in new technologies and systems and bias customer choices.

In addition to economically rational pricing, promoting the nation's interest in advanced telecommunications services requires policies that provide incentives and rewards for innovation. The Commission should establish clear ground rules for determining which services should be proprietary and therefore not subject to mandatory wholesale/resale requirements. Competitive players in telecommunications markets must be able to protect their innovations through patents, copyrights, trademarks and similar mechanisms, otherwise incentives for the investment in and development of innovative telecommunications services will be stifled.

Finally, the Commission, in establishing interconnection and competition policies, should recognize that it will be constrained in its ability to correct errors caused by "interim" policies. Public policies become treated as "entitlements." It should be assumed that policies intended to be transitional will become semi-permanent and difficult to modify. Experience suggests that there is a reasonably high likelihood that a policy designed to be transitory will outlive its value and ultimately may interfere with the original policy goals. One way to prevent this from occurring is by adopting policies now that are adaptive, self-correcting and market-based.

These are the issues addressed in this report. In Section B, we outline the contours of the current conditions in local exchange services. Assuming nondiscriminatory access to call termination, we note that the major barrier to efficient competition in local exchange services is not the market power of incumbents, but the regulatory obligations and restrictions imposed on the incumbents. In other markets, policy makers would be suspicious that prices set below costs were predatory and prices set well above costs constituted "monopoly" overcharges. Yet, in local telephone services, such pricing is seen as a virtue and is, in any case, compelled by current rate regulations.

We also distinguish, in Section B, the three main forms of entry into local exchange services: facilities-based (i.e., the entrant invests substantially in its own network); partial facilities-based (the entrant invests in its own network but also rents the use of unbundled network elements from facilities-based carriers); and resale (the entrant resells services purchased from a facilities-based carrier). We caution that while policies that enable entrants to

rent unbundled network elements or resell the services of facilities-based carriers can promote competition, such policies can also inhibit the development of facilities-based competition by distorting entrants' "make or buy" decisions.

Section C addresses specific policy issues raised by the NPRM and offers comments on the policy choices facing the Commission and state regulatory authorities. We explain why only call termination, not other interconnection services such as transport and tandem switching, should be governed by the Commission. We iterate one of the most fundamental propositions of economics: that the prices of goods and services – including those designated as essential facilities or services – should be priced to recover their full economic costs. Thus, LEC prices should reflect the total service long run incremental cost (TSLRIC), shared and common costs, a reasonable profit, and, during a transition period, embedded costs. *Any costing standards or methodology used to set prices must, therefore, when applied to the entirety of U S WEST's services, give U S WEST an opportunity to recover its total costs.*

That principle should be consistently applied in telecommunications, in the pricing of retail local exchange services, in the wholesale pricing of local exchange servicing, in the pricing of unbundled network elements, and in the pricing of call termination. We further show why, given the complexities and alternative means of interconnection, no system of tariffed prices can possibly reflect all of the myriad variations in interconnection arrangements. Hence, private negotiations among the parties are the only conceivable method of achieving rational, efficient interconnection.

In Section D, we begin with a discussion of the interplay between telecommunications policies, the strategies of competitors and the likelihood of success in telecommunications markets. Our point is this: whether or not the Commission intends for its rules to affect competition dynamics – who wins and who loses – its rules surely will have that effect. Recognizing that fact, the Commission should strive for policies that are competitively neutral, that allow competitors to succeed on their relative merits, and that do not magnify the inherent

advantages of major players such as AT&T to make competitive survival difficult for the diversity of other potential players.

To analyze the probable effects of alternative policy regimes, we construct and contrast the probable outcomes of two very different policy scenarios. In the "biased competition scenario," we assume that the LECs' retail prices are not restructured; wholesale prices are set below the cost of local exchange service (because they are established by discounts off of below-cost retail prices); excessive unbundling is required, with inadequate compensation to LECs for the cost of unbundling; and call termination and/or unbundled network elements are priced at or below incremental cost (e.g., by requiring "bill and keep"). The "efficient competition scenario" assumes instead the rapid adoption of economically rational retail pricing of exchange services through rate rebalancing; and prices of call termination, unbundled network elements and wholesale local exchange service cover full economic costs, reflect variations in costs, and enable LECs to earn a reasonable profit.

The expected outcomes of these two scenarios are quite different. By stressing unbundling and reselling over investment in facilities, policies that bias competition amplify the existing advantages of the major IXCs, facilitating their entry into local exchange services based on brand name and established customer bases. Customers' switching costs increase, reducing the vigor of price competition. Entry by smaller players is made more difficult, now and in the future. Investment in marketing and advertising is encouraged and rewarded, investment in new technologies, new services and local exchange facilities are discouraged.

Policies that promote efficient competition, in contrast, are likely to increase the dynamics of competition and the diversity of competitors. Efficient entry and innovation in technology and services are rewarded. The source of market success – and thus the grounds of competition – lie less in marketing than in offering better services at lower prices. Resale and unbundling would serve as complements to – rather than substitutes for – facilities-based competition. Hence, policies that promote efficient competition will promote investment in the nation's telecommunications infrastructure by the most efficient service providers. The Commission