market.[144] Thus, the price cap plan was intended to create economic incentives for the LECs to improve their productivity and to offer new services. At the same time, the structure was designed to protect consumers because "[s]ubdividing LEC services into baskets substantially curbs a carrier's pricing flexibility, as well as its ability to engage in unlawful cost shifting between the broad groupings of services."[145] The LECs that propose new basket structures, in particular USTA and its supporters, have ignored this important function of the current basket structure, and they have not shown any basis that would permit the Commission to conclude that the current level of

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[144] Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, 9 FCC Rcd. 1687 (¶ 38) (1994).

[145] LEC Price Cap Order, 5 FCC Rcd. at 6811 (¶ 200); First Report, 10 FCC Rcd. at 8974, 9126-27 (¶¶ 29, 379).

Within the traffic sensitive and trunking baskets, the Commission grouped similar services in service bands for the purpose of limiting "the LECs' ability to shift costs between services in a potentially anticompetitive manner." First Report, 10 FCC Rcd. at 9126-27 (¶ 379). As the Commission explained in the SFNPRM (¶ 93):

> "We created separate service categories in the price cap plan to group together services with high cross-elasticities of demand. This limits the LECs' ability to offset rate decreases for more competitive services with rate increases for less competitive services."

customer protection embodied in that structure is no longer needed.[146]

USTA, for example, recommends a revised basket structure that would group together rates for equivalent functions, consolidating a number of current service categories within the traffic sensitive and trunking baskets. This proposal disregards the fact that the current service categories are based on the grouping of services with high cross-elasticities of demand in order to limit the LECs' ability to offset rate decreases for more competitive services with rate increases for less competitive services. Services that may appear similar do not necessarily have high cross-elasticities and thus would create unwarranted opportunities for cross-subsidization.[147]

Further, the Commission correctly points out that if the lower service band index limits were eliminated as

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[146] Moreover, USTA's proposed restructuring does not provide the 'much-needed simplification' that it strives for. USTA at 36. Indeed, adoption of USTA's proposal would result in a more complex price cap structure, because it would eliminate service band indices at the service category level for those service categories which USTA asserts should be zone-priced. As a result, each zone would become an independent service category, creating 12 service categories in the trunking basket, instead of the six that currently exist.

[147] For example, voice grade and video are two different services with no cross-elasticities of demand. Similarly, due to significant differences in capacity (one DS3 is equal to 28 DS1s), DS1 and DS3 have different customer bases with limited cross-elasticities of demand.

proposed, then "consolidation of service categories would not provide any additional downward pricing flexibility, but instead would provide [solely] additional upward pricing flexibility by creating 'headroom' for services that are in the same service category with services for which the LECs have lowered their rates."[148] Allowing the LECs any additional pricing flexibility to increase their rates is detrimental to all of the Commission's major policy objectives. Given the lack of effective competition in the access and local exchange markets, it is abundantly plain that the price cap basket structure should not be revised at this time to afford additional pricing flexibility to the LECs. Nothing has occurred since the Commission's most recent revisions to the price cap baskets in the Second Report and Order less than five months ago that suggests it is no longer necessary to maintain the existing balance between LEC and ratepayer interests.[149]

Moreover, basket/band changes should follow and conform to structural changes in the access charge rules, as illustrated by the sequence of access and price cap changes

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[148] SFNPRM, ¶ 94.

[149] Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Second Report and Order and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd. 11098 (1995) ("Second Report and Order") (establishing a separate price cap basket for video dialtone services).

associated with the local transport restructure.[150] Historically, the Commission has modified price cap basket and service categories only after changes in market conditions or Part 69 rule changes have required such modification. Even then, due to the complexity of introducing, realigning and consolidating baskets and the impact of such changes on both the LECs' ratepayers and their potential competitors, the Commission has adopted modifications in the price cap structure only after extensive deliberations and analysis.[151] The Commission has announced the need for (and the recent telecommunications legislation requires) comprehensive access and universal service reform. Given that the Commission will be

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[150] See Frontier at 6; LDDS at 3 (in connection with access reform, the Commission could consider the commenters' numerous proposals to modify the existing price cap baskets and categories). In that context, AT&T generally supports Sprint's proposal (at 7-11) to phase out the carrier common line charge and the residual interconnection charge as soon as feasible. On the other hand, AT&T vigorously opposes USTA's (at Att. 6), NYNEX's (at 34), and BellSouth's (at 47) proposal to combine switching and common lines into one basket. These services are neither functionally equivalent nor cross-elastic. Moreover, they are likely to have very different competitive characteristics, including the availability of competing facilities and the geographic area in which competition may be available.

[151] See AT&T at 47. USTA's proposals for basket and service category revisions are not based on any demonstrated changes in the LECs' markets. Rather, USTA's proposals are supposed to ". . . facilitate the streamlining process by making it easier for exchange carriers to remove groups of service subcategories from price cap regulations." USTA at 37.

addressing access reform in the near term, it is inappropriate to revise the baskets and bands now, in advance of determining what the revised access charge rules will be.

Realignment of baskets and bands would also require readjustment of the LECs' productivity or X-factor, which the FCC is currently calibrating in light of the current structure.[152] The Commission's ability to measure the LECs' productivity gains would be rendered substantially more complex if the Commission continuously revised the composition of the baskets, because changes in productivity cannot be measured without comparison with historical productivity gains. If the Commission were to start moving major service categories from one basket to another, and creating separate baskets for large and small customers, it would be almost impossible to measure LECs' productivity gains.[153]

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[152] See Fourth Further Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 95-406, released September 27, 1995 ("X-Factor Notice").

[153] USTA's optional basket structure, which combines the local switching and common line baskets and establishes separate combined baskets for large and small customers, respectively, would likely require recomputing the appropriate productivity factor which was set on a company-wide basis, but was designed to be appropriate for each basket. See LEC Price Cap Order, 5 FCC Rcd. at 6812 (¶¶ 209-10).

AT&T agrees that some alterations in the price cap basket structure may be warranted if competition develops,[154] but there is no meaningful facilities-based competition in access and local exchange markets today. Thus, at this time, market forces cannot replace the consumer protections provided by existing price cap controls. In the absence of market forces to restrain LEC pricing behavior, any changes to the current price cap structure to provide the LECs additional pricing flexibility would harm customers. Thus, the basic structure of LEC service baskets and service categories should be retained to preclude excessive rates and cross-subsidies.

The Commission expressly recognized that it may be necessary to reexamine the composition of baskets and bands, as competition develops in local markets, to guard against anticompetitive cross-subsidization.[155] Thus, the Commission should evaluate proposals to realign services within the service bands or to consolidate service bands, based on a showing of major changes in the competitive characteristics of the services that would be affected and whether the proposed modification would protect ratepayer interests.

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[154] See AT&T, App. A at 21-22.

[155] First Report, 10 FCC Rcd. at 9141-42 (¶ 414).

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

In general, the LECs oppose the Commission's proposal to create a new service category for operator services in the traffic sensitive basket. Bell Atlantic and Pacific contend that operator services are competitive with IXC-provided services and should be removed from price cap regulation altogether.[156] By contrast, other LECs support inclusion of operator services in the information category within the traffic sensitive basket.[157] None of these positions makes sense.

As the Commission correctly tentatively concluded in the Operator Services Notice, the current lack of a rule mandating the classification of operator services has given the LECs an unwarranted ability to raise rates for operator services relative to their other traffic sensitive or interexchange rates.[158] This would not be the case if these

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[156] Bell Atlantic at 23-24 (stating that operator services should be assigned to the interexchange basket, as a precursor to price deregulation of all services in that basket); Pacific at 31.

[157] BellSouth at Att. 2; GTE at 40; NYNEX at 19; U S WEST at 30.

[158] See Treatment of Operator Services Under Price Cap Regulation, 8 FCC Rcd. 3655 (¶ 4)(1993) ("Operator Services Notice"). See AT&T at 52-53. This same holds true for the LECs' Line Information Data Base ("LIDB") services. Accordingly, the Commission should create a LIDB service category in the traffic sensitive basket. AT&T at 54.

services were in fact competitive. Bell Atlantic's and Pacific's assertions that operator services are "fully competitive" is flatly wrong, and is in fact undercut by NYNEX's observation that they are not.[159]

Only the LECs can provide operator transfer and busy line status verification/interrupt ("BLV/I").[160] Although an end user can access an IXC operator directly (e.g., by dialing 1-800-CALL-ATT) that does not mean that LEC-provided operator transfer, on which many consumers depend to reach the IXC operator, is competitive. Moreover, BLV/I service is dependent on a LEC backbone network separate from the one that transports the call, and no other provider currently competes with the LEC for this service. Thus, price cap controls remain imperative for these services.[161]

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[159] NYNEX at 19 n.17; see also Frontier at 10.

[160] "Operator transfer" occurs when a LEC operator receives a 0- interLATA call and the LEC transfers the call automatically to the IXC selected by the caller. "Line status verification" or BLV/I occurs when the operator checks the line for an IXC operator to determine whether it is busy or out-of-service and interrupts if it is busy and an emergency exists. SFNPRM, ¶ 96. The fact that some niche Operator Services Providers ("OSPs") can perform 0+ call completion does not make the LEC-provided operator services identified above competitive, because the OSP functions are distinct from the monopoly LEC functions.

[161] Similarly, while some aspects of directory assistance are available from vendors other than the LECs, none of these vendors can provide the same quality of service as the incumbent LEC, which has the most complete and up-to-date customer listing information database, precisely because

(footnote continued on following page)

Contrary to some LECs' suggestions, operator transfer and BLV/I should not be included in the information band, but rather should be placed in their own separate service category in the traffic sensitive basket, as the Commission has proposed.[162] Because the LECs have broad pricing flexibility among services within a given service category, the Commission has properly taken into account in establishing each service category, whether services have high cross-elasticities of demand. Such cross-elasticities can limit "the LECs' ability to offset rate decreases for more competitive services with rate increases for less competitive services."[163] Because operator services are not cross-elastic with other LEC offerings, they should be placed into their own service category in the traffic sensitive basket to "limit the LECs' ability to shift costs

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(footnote continued from previous page)

of its superior access to customer data as a result of its monopoly status. Thus, assertions that directory assistance should be removed from price cap regulation are also without merit. See Bell Atlantic at 23-24; NYNEX at 19 n.17; Pacific at 31. Moreover, as AT&T (at 53-54) showed, directory assistance-related call completion service should be placed in the information service band, because this service requires access to LEC directory listings.

[162] AT&T at 54; MCI at 20; Time Warner at 20.

[163] SFNPRM, ¶ 93.

between services in a potentially anticompetitive manner."[164]

CONCLUSION

For the reasons stated above and in AT&T's Comments, the Commission should not relax LEC price cap rules in anticipation of the emergence of competition in access and local exchange markets. Rather, the Commission should assure that the preconditions for competition are effectively implemented.

Respectfully submitted,

AT&T CORP.

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February 6, 1996

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[164] First Report, 10 FCC Rcd. at 9126-27 (¶ 379). See AT&T at 51-52 and n.108. Operator-related call completion service should likewise be included in the operator service category, because it depends on use of the LECs' operator services. AT&T at 54.

LIST OF COMMENTERS

Ad Hoc Telecommunications Users Group ("Ad Hoc")

Ameritech

Association for Local Telecommunications Services ("ALTS")

AT&T Corp. ("AT&T")

Bell Atlantic Companies ("Bell Atlantic")

BellSouth Telecommunications, Inc. ("BellSouth")

California Cable Television Association ("CCTA")

Cincinnati Bell Telephone ("CBT")

Comcast Corporation ("Comcast")

Competitive Telecommunications Association ("CompTel")

Frontier Corporation ("Frontier")

General Services Administration ("GSA")

GTE Service Corporation ("GTE")

ICG Access Services, Inc. ("ICG")

Information Industry Association ("IIA")

Information Technology & Telecommunications Association ("ITTA")

LCI International, Inc. ("LCI")

LDDS Worldcom, Inc. ("LDDS")

MCI Telecommunications Corporation ("MCI")

MFS Communications Company, Inc. ("MFS")

National Cable Television Association, Inc. ("NCTA")

New York State Department of Public Service ("NYDPS")

NYNEX Telephone Companies ("NYNEX")

Organization for the Protection and Advancement of Small Telephone Companies ("OPASTCO")

Pacific Bell and Nevada Bell ("Pacific")

Southern New England Telephone Company ("SNET")

Southwestern Bell Telephone Company ("SWBT")

Sprint Corp. ("Sprint")

Sprint Telecommunications Venture ("STV")

Telecommunications Resellers Association ("TRA")

Teleport Communications Group, Inc. ("TCG")

Time Warner Communications Holdings, Inc. ("Time Warner")

United States Telephone Association ("USTA")

U S WEST Communications Inc. ("U S WEST")

APPENDIX B

BELLSOUTH
EUROPE

Comments of BellSouth Europe to the European Commission's Green Paper on the Liberalisation of Telecommunications Infrastructure and Cable Television Networks

March 15, 1995

Introduction

BellSouth Europe is pleased to provide written comments to the Commission regarding the "Green Paper on the Liberalisation of Telecommunications Infrastructure and Cable Television Networks" (the "Green Paper").

BellSouth, one of the world's leading telecommunications companies, has a long-standing commitment to Europe and maintains a headquarters office in Brussels. By following its strategy to develop business projects in the EU in partnership with strong local partners, BellSouth is participating in cellular operations in Denmark (Sonofon) and Germany (E-Plus), and mobile data operations in Belgium, Germany, France, The Netherlands and the U.K.

BellSouth has also gained considerable experience in the area of competitive networks through its operations in the United States, as well as its leadership as the key operator in Optus, the second carrier in Australia, and BellSouth Chile, a long-distance carrier in South America. With its wireless operations in Europe as a base, BellSouth is now transferring its capabilities in the competitive network area to support the Commission's initiatives to bring the benefits of competition to Europe. The initial result of this strategy has been the recent selection of BellSouth as the operating partner in the Telecom-2 consortium, which expects to be granted a license to operate a second infrastructure-based wireline network in The Netherlands.

BellSouth endorses the Commission's efforts to liberalize the European telecommunications market and agrees to many of the principles suggested in the Green Paper. BellSouth however wishes to comment on some of the key issues of the paper in this submission, including the industry structure, the framework for interconnection, and the universal service obligation.

I. The Need for "Constructive Competition"

The expressed intent of the telecommunications liberalization initiatives as framed by the Green Paper is the creation of an environment to allow Europe to compete more effectively in the global economy. This competitive effectiveness will require superior information access, processing and transmission capabilities. Implicit in the "Green Paper" is the premise that these superior capabilities can only be gained via a superior telecommunications infrastructure fabricated from effective competition and significant private funding. The "Green Paper" further notes that significant private funding depends on investment certainty borne of a stable regulatory regime in which "non-commercial political burdens" are removed and reasonable expectations of profitability are inherent. BellSouth Europe emphatically concurs.

From this position, the "Green Paper" concludes that open, unrestricted infrastructure competition and effective competition are synonymous. In many cases, this is true. Open competition drives prices toward marginal costs thereby maximizing social surplus. This makes good economic policy in the majority of sectors wherein marginal (or, incremental) costs exceed average costs. It is not however good economic policy in those sectors in which incremental costs are chronically less than average costs. If prices equal incremental cost and incremental cost is less than average cost, investors cannot possibly recover their capital, much less realize reasonable profitability. Under these conditions rational investors would not invest.

These conditions have been observed in practice. The airline industry is an example of a segment in which incremental costs are significantly less than average fixed costs. The International Telecommunication Union (ITU) has noted the on-going effects of "destructive competition" in this sector with some disturbing implications for the telecommunications sector:

"... the international airline industry has lost almost US $16 billion between 1990 and 1992. This is greater than the cumulative profits achieved by the industry in its first 60 years of existence."[1]

Destructive competition in the international airline industry was foreshadowed by proportionate operating losses and market failures in the U. S. where deregulated, open competition has been in effect for over 15 years. The ITU goes on to note that:

"The telecommunication service industry and the airline industry have much in common."[2]

In addition to high fixed cost and relatively low incremental cost similarities,

"Both are undergoing deregulation and are subject to the introduction of competition... But the recent experience of growth and profitability in the two sectors has been markedly different... So why the big difference in the fortunes of the two

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[1] World Telecommunication Union Report 1994, International Telecommunication Union, Geneva, Switzerland, 1994, p. 8.

[2] Ibid

industries? The main reason appears to be that the process of deregulation and competition has extended much further in the airline industry than in the telecommunications industry. This has been expressed as price wars (in the airline industry)... If the airline industry is to be taken as a model for the future of telecommunications, then there are some important lessons to be learned."[3]

The fundamental lesson appears to be that open competition is not sustainable in a declining cost industry. Based on US airline experience, the sequence appears to involve a protracted initial phase in which massive amounts of money are lost and market failures are commonplace. The initial phase appears to be followed by a market consolidation phase in which the stronger players acquire their weaker competitors. Ultimately, the market is expected to be rationalized into a relative few survivors capable of sustaining viable competition.

Open competition is supposed to eliminate the incapable and make the capable more capable--but it is questionable whether the public good is truly served by the economic carnage that precedes market consolidation. As exemplified by the US airline industry, price wars produce transitory below-cost prices for consumers. In the short-run, that is good from the consumer's perspective, but it masks concomitant deterioration in service quality as competitors frantically cut costs to attempt to stay afloat. Investors simply will not risk capital under these circumstances to upgrade the industry's productive assets. Ultimately, "economic Darwinism" will rationalize the market as indicated above, but the cost will be high. Europe cannot afford the delay in reaching the same stage of market evolution that some of its international competitors have already reached.

Given the fact that some of Europe's international competitors are years ahead in rationalizing their telecommunications markets, is there some way to leapfrog the market carnage phase of open competition, identify the probable survivors and in effect, consolidate the market ahead of time? Just how hard is it to identify probable survivors? Are their identities so nebulous that we must let the market take 10-20 years to decide the issue? Consider the US. long distance market. The 1978 EXECUNET decision effectively opened that market to competition. Would a 1978 observer have projected MCI and AT&T as the principal market survivors in 1995? BellSouth believes the answer is "yes".[4]

Based on the above, BellSouth Europe recommends that the European Commission adopt the general principle that liberalization of telecommunications infrastructure limit competitive entry to a managed number of entrants until such time as effective competition is achieved (i.e., when no single carrier has dominant market power).

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[3] Ibid.

[4] Since it was the product of multiple mergers and acquisitions, it would not have been possible to project Sprint as a survivor in 1978. On the other hand, Sprint holds less than 10% of the U.S. long distance market by most measures and it is therefore questionable whether Sprint is principal market survivor or simply a niche player.

II. The Need for Economically Efficient Interconnection Charges

A. Development of a Framework for Interconnection

It is fairly common for interconnection charges to constitute 40-60% of a typical alternate telecommunications service provider's total operating costs. This emphasizes the importance of reasonable interconnection charges for the creation of sustainable competition. It would not be an overstatement to say that the success or failure of the European Community's telecommunications liberalization initiatives may hinge on the establishment of an appropriate framework for the establishment of these charges.

This framework should include the setting of objectives that promote economic efficiency through effective competition. In other words, interconnection charges should:

- Reflect cost causation
- Stimulate efficiency
- Promote effective competition

BellSouth Europe supports the concept that the cost causation principle is inherent in long-run incremental costs (LRIC). Both the WIK/EAC and Arthur Andersen interconnection studies prepared for the Commission, support the cost causation nature of LRIC. These studies also report the paradox that European regulators universally use Fully Distributed costs (FDC) as the basis for pricing decisions. There is sufficient reason for using FDC for pricing in monopoly markets. By virtue of its basis in the typical PTT's accounting system, FDC is conceptually simple, auditable and "balances to the books" but, unfortunately, it is not consistent with cost causation. It is therefore not useful for pricing decisions in competitive markets. The WIK/EAC study notes that *"... reported costs are often not at all reflective of the actual cost causation."*[5] The Arthur Andersen study conclusively demonstrates the fallacy of using FDC for economic decision-making in its graphic "Death Spiral" example.[6] With convincing evidence that FDC in all its variant forms cannot support the development of cost-based interconnection, BellSouth Europe supports the Green Paper's (Part II, p. 73) position that *"Regulatory authorities should have a responsibility ... for ensuring ... cost-oriented pricing structures..."* This should be done by insisting on LRIC-based interconnection charges.

"One of the prime motivations for liberalising the telecommunications sector is that incumbent operators are believed to be inefficient."[7] Based on liberalization efforts outside the European Community (U.S., U.K., Australia, etc.), there is ample

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[5] Network Interconnection in the Domain of ONP. Wisenschaftliches Institut fur Kommunikationsdienste/European-American Center for Policy Analysis (WIK/EAC). Bad Honef, Germany, 1994, p. 89.

[6] Arthur Andersen Study Prepared for the Commission of the European Community DG XIII. 1994, Appendix 3.

[7] Ibid., p. 63.

evidence this is true. In the U.S., for example, Regional Bell Operating Company productivity in terms of access lines per employee has more than doubled since divestiture in 1984. Efficiency improvements have a direct impact on international competitiveness and thus a nation's future economic health will be significantly affected by the relative efficiency of its incumbent carrier. In this vein, the Arthur Andersen study notes:

"As far as interconnect is concerned it involves ... setting interconnect charges which give incentives to the incumbent to improve its efficiency."[8]

The study goes on to suggest a way to accomplish this goal is to adjust specific components of the interconnection charge:

"There should be only partial funding of the local access loss. This will incentivise the incumbent to improve efficiency in the provision of local access."[9]

As indicated above, incumbents have ample room to finance these and other adjustments through efficiency improvements. In Australia, where the new alternate carrier's interconnection charge contains no explicit local access loss component, the incumbent, Telstra, reports record profits as a direct by-product of its efficiency improvements efforts. AT&T's Chief Executive Officer Robert Allen has stated in U.S. congressional committee hearings that competition has made AT&T a more profitable company because of AT&T's greatly increased efficiency. The record is clear--effective competition benefits the incumbent. To date, the record does not present as positive a picture for the newcomers.

After 15-20 years of competition, AT&T still commands 2/3 of its contested US long distance market and BT has only surrendered about 10% of its overall market (while Mercury reports operating losses and becomes more of a niche-player by recently exiting certain markets). The conventional assumption that ex-monopolists are easily attacked by their new, market-hardened competitors has proven wrong for two fundamental reasons:

- Monopoly-bred inefficiency plays into the incumbent's hands by (1) enabling dramatic improvements in operating results through relatively easy "fat-cutting" and (2) justifying high interconnect prices designed to largely recoup the incumbent's past inefficiencies. The combination of high prices and significantly reduced costs virtually guarantee the kind of economic rejuvenation Telstra, Telecom New Zealand, BT and other incumbents have experienced with the onset of competition.

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

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[8] Ibid., p. 166.
[9] Ibid., p. 185.

The WIK/EAC study takes note of the incumbent's inherited structural advantages in its executive summary:

"Even with interconnection charges set as low as marginal or average incremental costs, the incumbent is unlikely to lose its market quickly. Usually there are sunk costs (that entrants have to expend), switching costs by customers, name recognition, brand loyalty and other advantages of the TO over entrants that prevent consumers from switching to entrants even at substantially lower prices. For example, in the UK, Mercury only gained about 10% in its first ten years."[10]

The Arthur Andersen study comes to the same conclusion. It goes on to suggest how this formidable barrier to effective competition can be offset:

"One practical way to offset such structural advantages is to give the competing new entrants temporary abatements of interconnect charges, expressed in terms of a percentage of the charges paid by the entrant for the interconnect capabilities it receives. This was the approach adopted in the U.S. after the initial divestiture of AT&T."[11]

As regards this last point, MCI received interconnection price abatements as high as 65% [the so-called Exchange Network Facilities for Intercity Access (ENFIA) discounts] until the late 1980s--ostensibly to compensate for unequal access. Entrants' unequal access to the local network is second only to high interconnection prices as the most formidable barrier to effective competition. Equal access involves the following principal components:

- Preselection
- Neutral Provisioning
- Ubiquitous end office access
- Unbundled interconnection charges

In short, equal access means the incumbent and the entrant share the same mode of access to their respective customers and, furthermore, their customers have the same mode of access to their carrier of choice. It also means that infrastructure requested by the entrant's and the incumbent's service provision (retail) units receive the same level of priority of provisioning, service and repair:

"Competitors are disadvantaged if they cannot order and obtain leased lines, circuit rearrangements, and enhanced services on reliable commercial schedules that are equivalent to the service a TO provides to its own departments or subsidiaries. Experience in liberalised markets (U.S., U.K.) suggests that regulators need to establish a requirement for equal provisioning and to monitor TO performance to ensure equal access."[12]

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[10] WIK/EAC, p. 10.
[11] Arthur Andersen, p. 172.
[12] WIK/EAC, p. 37.

Possibly the most effective way to ensure equal access and confidential treatment of entrant's commercially-sensitive traffic data is to separate the TO's infrastructure (wholesale) and service provision (retail) units into different organizations under a TO holding company. The creation of such an organization may also lead to significant efficiency gains. Telecommunications infrastructure is characterized by high fixed costs, low marginal costs and overall economies of scale. An infrastructure organization's operating results are thus improved to the extent it is able to spread its fixed costs over a wider circle of paying customers. Such an organization would tend to welcome new business whether it came from an entrant or the incumbent's own service provision unit. The incumbent's service provision unit would naturally take a contrary view. The best ways to ensure neutral treatment for all service providers is to organizationally separate the incumbent's infrastructure and service provision units.

In summary, BellSouth Europe's comments regarding a framework for the development of interconnection charges are:

- Interconnection charges will have a major impact on the potential success of infrastructure liberalization
- Interconnection charges should reflect cost causation and, as such, should be based on long-run incremental costs (LRIC).
- Interconnection charges should motivate incumbent efficiency.
- Rather than handicapping incumbents, past monopoly-bred inefficiencies often greatly advantage these incumbents when competition with new entrants requiring interconnection begins.
- Incumbents bring enormous structural advantages to competitive situations.
- To develop effective competition, interconnection charges must be adjusted to motivate incumbent efficiency and counterbalance the incumbent's considerable structural advantages.
- Effective competition is largely dependent upon equal access to infrastructure by competing parties. This is most easily accomplished by organizationally separating the incumbent's infrastructure and service provision units. Where equal access does not exist, interconnection charges should be adjusted to achieve the same competitive effect (e.g., the AT&T ENFIA discount to MCI).

B. Development of Interconnection Charges

Although not specifically acknowledged in either the WIK/EAC or Arthur Andersen reports, it is nonetheless clear that developing the right set of interconnection charges is not subject to mathematical certainty. The necessary adjustments to interconnection charges cited above can only be subjectively determined. This fact disturbs many regulators since subjective decisions are the most difficult to defend. This does not mean reasonable bounds (so-called "sanity checks") cannot be established for interconnection charges. Enough experience with interconnection charges has been gained over the past several years to establish bounds of reasonableness.

Australia has demonstrated that a busy period composite access charge rate of approximately 0.023 US$ per minute in concert with partial equal access produced record profits for the incumbent, Telstra. It also enabled the new entrant, Optus, to apparently develop a viable business. This suggests that full equal access and the same composite access charge rate may be within an appropriate range. The Arthur Andersen study cites a recent OVUM study of worldwide interconnection charge experience.[13] The OVUM study found that whatever the theoretical basis for setting charges, new entrants need to have interconnection charges of less than approximately 0.010 US$ for a three-minute call to create and maintain a viable business. This correlates fairly well with Australian experience. Regulators should thus be fairly confident that peak period interconnection charges in the range of 0.02 to 0.03 US$ per minute for essentially equal access are reasonable. In fact, to avoid the long drawn-out, litigious interconnection charge "negotiations" that have occurred in the past, European regulators should initially establish a range of reasonable outcomes. The Australian regulatory agency, AUSTEL, did this with great success as noted by the ITU in its report:

"More often than not interconnection arrangements have been established only after a new market entrant has been licensed and the consequent delays have greatly handicapped the expansion of new services. This has been the case in the United States, the United Kingdom, New Zealand and most recently, Poland. In Australia, the regulatory body, AUSTEL, laid down principles for equitable interconnection from the outset and this has meant that a competitive environment has been established much more quickly than in other countries. Regulators elsewhere in the world looking to license new market entrants would do well to follow AUSTEL's example."[14]

Beyond establishing principles, AUSTEL prescribed the 0.023 US$ composite peak period interconnection charge cited above before Optus and Telstra initiated interconnection negotiations. With this behind them, a workable agreement framework was completed in about six weeks with only minimal need for AUSTEL arbitration.

BellSouth Europe agrees with the ITU that regulators would do well to follow AUSTEL's example in establishing interconnection parameters at the start of the liberalization process. Regarding use of the Australian approach to telecommunications liberalization as a model, the economist Henry Ergas comments:

"Competition is likely to establish itself relatively quickly in significant parts of the Australian market... This is for three primary reasons. The first is that the government has put in place a framework of competitive safeguards which anticipates and solves in advance many of the difficulties which have hindered the establishment of competition in the other markets where liberalisation has been attempted... this framework should significantly reduce the lead time involved in the transition to competition and allow an early move to a fully commercial market. A second reason has to do with the selection of the competing carrier. In the United

[13] Arthur Andersen. p. 181.
[14] ITU. p. 69.

Kingdom and the United States, the transition to competition involved entry by players with little experience of major common carrier markets and whose financial resources were slight relative to the task they were taking on. In contrast, the winning consortium in Australia involves major foreign carriers which ... have similar or even greater technical resources than the incumbent carrier and ... ready access to finance. It is only natural to expect that this will be reflected in a more rapid erosion of the incumbent's bottleneck control... Finally, the fact is that the Australian market involves relatively powerful and sophisticated major customers, well aware of the range of services and service options available in competitive markets overseas... Taken together, these factors mean that the development of workable competition in Australian telecommunications will be measured in years rather than, as in the United Kingdom and the United States, in decades... This is primarily because the greatest benefits of liberalisation come not from the inroads made by the entrants, but from the improved performance by the incumbent. In no country have the entrants secured more than 15 to 20 percent of the market as a whole, and even in the Australian circumstances they are unlikely to secure much more. What really counts for improved economic performance are, consequently, the efficiency gains made in the remaining 80 percent, that is, the market held by the established carrier."[15]

In light of the market liberalization lead established by some of its major trading partners, the European Community should reduce the period required to reach the benefits of effective competition by avoiding the mistakes of these trading partners as Australia has done. This suggests a need for close attention to the Australian model.

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[15] Ergas, Henry, "An Alternate View of Australian Telecommunications Reforms," from Implementing Reforms in the Telecommunications Sector--Lessons from Experience, edited by Biorn Wellenius and Peter A. Stern, The World Bank, Washington, D.C., 1994, p. 250.

III. The Need to Harmonize Public Policy, International Competitiveness and Economic Efficiency

Economic efficiency theory does not address those situations in which there are compelling social reasons for producing designated goods and services at prices which do not cover production costs. Historically, universal telephone service has been one of these designated goods and services. The social costs of universal service have traditionally been recovered via internal cross-subsidies provided by consumers of other telecommunications services including interlocal and international long distance. It is in this context that European Community member states and their global trading partners face the need to reconcile the social impact of growing global economic competition with potential technological expansion of universal service. In concert with the consensus that a society's telecommunications capabilities and its ability to compete in the global economy are tightly correlated, the question becomes to what extent any member state should compromise economic efficiency by significantly expanding universal service.

The "Green Paper" appears to suggest that such a compromise is worthwhile to provide egalitarian access to advanced telecommunications services, possibly including multimedia. BellSouth Europe suggests this may be feasible via some changes in the way universal service is funded; i.e., there may be a means of bridging some of the gap between economic efficiency and expanded universal service.

If expanded universal service is a reasoned response to vital public demand, the discipline imposed by correlating cost causation with cost recovery can be at least partially maintained via public funding. In this way, the expanded cost of universal service can be spread over all economic sectors avoiding disproportionate impact on the telecommunications sector and international competitiveness.

Since most developed countries support the traditional definition of universal service, BellSouth Europe does not see immediate threat to the European Community's relative international competitiveness by continuing to fund universal service via the telecommunications sector alone. There are time constraints, however, on viably maintaining the status quo. Some of Europe's international trading partners are considering measures that would limit the impact of universal service on economic efficiency. These measures include:

- Targeting subsidies to the truly marginal consumer.
- Rebalancing local service and long distance tariffs to better align prices with costs.

Proponents of these measures maintain universal service's fundamental social aims can be realized without unduly compromising economic efficiency:

"The breakup of AT&T in 1984 into a long-distance (and manufacturing) component and seven local-service companies, the Bell operating companies, created the opportunity for billions of dollars of annual economic efficiency gains for the U.S. economy. These potential annual efficiency gains arise in part from the

establishment of a rational price system for telephone services. At the time of the breakup (and to a lesser extent today) basic *access to the telephone network received a large cross subsidy from other telephone services; that is, the price of basic access was well below its incremental (or marginal) cost. The largest component of this cross subsidy arises from the prices of long-distance services which are well in excess of their incremental cost.*

... Economists were aware of this problem and in the 1970s recommended that long distance prices be decreased and basic (local) access prices be increased, which eliminates the loss in economic efficiency. Income-distribution problems arise, but these problems can be solved by a <u>*targeted subsidy*</u> to *low-income households...*

Our (price elasticity) estimates also find an important effect of long distance prices on the demand for basic (local) access. Indeed, the effect of long distance prices is sufficiently large that a revenue-neutral <u>*rebalancing*</u> *of telephone prices, which would reduce the subsidy for basic (local) access and lower long-distance prices would lead to large gains both in economic efficiency and increased telephone penetration in the United States. Thus, the perceived trade-off between economic efficiency and telephone penetration (universal service) is unlikely to exist anymore."*[16] (Emphasis and parenthetical remarks added)

In fact, telephone penetration <u>increased</u> from 91.4 percent to 93.3 percent of US households in the 1984-1990 period.[17] During this period, basic local service prices <u>increased</u> about 35 percent. This increase was balanced by long distance <u>decreases</u> of about the same amount. Targeted subsidies in the form of deeply-discounted "lifeline" local service rates were also made available to low-income households during this period. A policy of targeted subsidies and tariff rebalancing in the U.S. has had the dramatic effect of improving both economic efficiency and universal service. The Hausman, et al., study however notes that steps in the United States toward cost-based pricing are well short of the goal:

"... the current combination of federal and state policy toward regulation of telephone service in the United States has an efficiency loss in the billions of dollars and retards the advancement of the "Information Age" which many individuals believe will increase productivity and lead to many new services for telephone consumers."[18]

Both the WIK/EAC and Arthur Andersen studies agree that the long-term objective should be to remove from the telecommunications sector the burden of financing social policy (universal service, below-cost local service and geographic averaging). As demonstrated in the U.S., a carefully crafted system of targeted subsidies, tariff balancing and public funding has the potential to realize both important social objectives and improved economic efficiency. The Arthur Andersen study points out that tariff rebalancing alone can reduce appropriate universal service obligations

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[16] Hausman, Jerry, Timothy Tardiff, and Alexander Belinfante, "The Effects of the Breakup of AT&T on Telephone Penetration in the United States," Federal Communications Commission, 1990, pp. 178-179.

[17] <u>Ibid</u>., p. 182.

[18] <u>Ibid</u>., pp. 183-184.